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FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1980

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

ON

OVERSIGHT ON MONETARY POLICY PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

JULY 21 AND 22, 1980

Printed for the use of the Committee on
Banking, Housing, and Urban Affairs

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FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1980

MONDAY, JULY 21, 1980

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, D.C.

The committee met at 10 a.m., in room 5302, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The Chairman. Today we begin 2 days of hearings on the conduct of monetary policy by the Federal Reserve. We have as our witnesses this morning three well known and highly respected economists: Mr. Mark Willes, who is the chief financial officer of General Mills, Inc., and who was until July 1 the president of the Federal Reserve Bank of Minneapolis; Dr. Robert Parry, senior vice president and chief economist of the Security Pacific National Bank, Los Angeles; and Dr. Allan Sinai, vice president, Data Resources, Inc., Lexington, Mass.

Tomorrow Chairman Volcker will appear before the committee to announce the Federal Reserve's targets for growth of the monetary and credit aggregates for the remainder of 1980 and for calendar year 1981. Since last October the Fed has been following a new type of policy plan in which it concentrates on controlling bank reserves in order to control growth of the monetary and credit measures. I think that these policies have been appropriately restrictive so as to work toward reducing inflation and inflationary expectations.

During the first half of this year growth of the monetary and credit aggregates was below or near the bottom of the target ranges adopted by the Federal Open Market Committee in February. So we have a situation where the Fed can encourage money and credit growth over the second half and still meet its targets. However, there is a danger in pursuing such a course of action too aggressively because monetary control is very imprecise and the lags are long. Thus, money and credit growth that is too rapid may be hard or impossible to reverse and a new wave of inflationary expectations could be set loose. The safest course of action now would be for the Fed to foster money growth toward the lower end of the target ranges adopted in February. This would provide sufficient money and credit over the remainder of the year to permit the economy to come out of the recession in an orderly manner.

Gentlemen, as you know, the committee must issue a report on monetary policy following these hearings. So I am going to ask you to play the role of member of the Open Market Committee and give us your views on where the Federal Reserve should be going with respect to its efforts to control the growth of money and credit. Mr. Willes, I know that you have actual experience with this role so I will ask you to lead off. But, before you do, let me share with you several questions I think we need to have answers to as we consider monetary policy between now and the end of 1981.

First, what should the monetary and credit targets be for the remainder of 1980 and for calendar year 1981? Should we be concerned with the failure of the Fed to come within the range of the targets so far for this year and they've been well below. As you know, in the past it's been far above it; and I have complained about how wide the ranges have been. It's almost like the old saying, "You couldn't hit the broad side of the barn door if you fell against it." It's almost uncanny that they can miss the targets so consistently and it's hard for me, as chairman of this committee, to understand that.

Second, I'd also like your views on a fascinating development because our next President may be a man, Governor Reagan, who has indicated his interest in returning to the gold standard. Lawrence Kudlow, the chief economist for Beare-Sterns, has also indicated that he thinks the gold standard might be the right policy. It has seemed so far out and so extreme to many of us for so long that we have rejected it out of hand. But with that kind of respectable support, we ought to at least understand what the consequences would be.

Third, Then I'd like to know, whether the Federal Reserve should adopt a longer-run policy scenario that would have as its centerpiece the gradual reduction of the rates of growth of the monetary and credit aggregates to levels that are consistent with the economy's potential to increase production and productivity?

Fourth, has the Federal Reserve's switch to procedures for controlling bank reserves rather than short-term interest rates aided monetary policy? Have the new procedures helped control of the aggregates and inflation? And, has the Federal Reserve actually stuck to its commitment to permit interest rates to fluctuate and be market established?

Fifth, now that we have in place a system of universal reserve requirements, would monetary policy be aided by linking the discount rate with market rates?

Sixth, to what extent should the Federal Reserve adjust monetary policy to changes in the value of the dollar internationally?

Seventh, given the economic environment and the likelihood of a fiscal year 1980 budget deficit on the order of $50 to $60 billion, with a sizable deficit in 1981, would you recommend a tax cut? If so, what type of cut, and when? And, would this have any effect on the Federal Reserve's ability to achieve its targets?

Finally, what steps should the Congress be taking to reduce inflation?

Gentlemen, I look forward to your testimony. Mr. Willes, as I indicated, we would appreciate your leading off.

STATEMENT OF MARK H. WILLES, CHIEF FINANCIAL OFFICER, GENERAL MILLS, INC. MINNEAPOLIS, MINN.

Mr. **Willes**. Thank you. Mr. Chairman.

I appreciate the opportunity of testifying before this committee. I appreciate the invitation to rejoin the Federal Open Market Committee. I hope that those with whom I sit today agree more substantially with me than my former colleagues did when I was a real member of that committee. I must say my current salary is substantially better than the one I held in my former position and I'm grateful for that.

I assume you want us to stick to the 10-minute time period and still try to answer all those questions.

The **Chairman**. If you can. If you can't, maybe we can get to those questions after your initial oral statement.

Mr. **Willes**. Well, I think you received a copy of my written testimony so I will not go through that. Let me just make a couple comments by way of summary and also to answer the questions which you raised, maybe starting with the fact that as a former member of the Federal Open Market Committee and now looking at it from the outside, I really am very pleased with the actions that were taken last October 6. I was a little disappointed that they took those actions when I was out of the country so I couldn't vote in favor of them, but I think that they have shown real courage so far in sticking essentially to the plan which they announced last October which was to place increasing emphasis on the growth of the monetary aggregates and substantially less emphasis on short-term fluctuations in interest rates. I put a chart in my written testimony that shows how much more dramatically interest rates have fluctuated in the short term since October 6 than they did before, which I think is fairly interesting evidence that they really have done by and large what they said they would do.

Now I read in the press periodically as we see some of FOMC minutes released, that there has been discussion in the committee right along that we ought not to lose sight of short-run fluctuations in interest rates. To be sure there have been times when I think that served as a minor constraint on what the committee was willing to do, but I think by and large the committee has done what it said it would do and I frankly have great admiration for Chairman Volcker and my former colleagues for what they have done.

The real question in my mind is whether they will stick to it over the long term and explicit in the questions you asked I think was an understanding that if policy is to have real credibility and real effectiveness—and the two go hand in hand—a monetary policy for 6 months is good, but it's nowhere near enough, and you have to have a relatively stable, long-term monetary policy. Otherwise, we will simply fritter away the gains that I think we may be beginning to make.

Having said all of that, it was explicit in my testimony and I would simply emphasize again that I think it's critically important that the Fed stick to its monetary targets. I wish it weren't below the range, but that doesn't surprise me and I really think that that can be accounted for in part by the difficulty the Fed is having readjusting to its new procedures and it just takes a while to operate in a different environment.

Money seems to be coming back now to within that range and I would expect it to stay within the range.

TEST FOR MONETARY POLICY

I think the real test for monetary policy will come later this year or early next year when as the economy strengthens and that starts to put an upward pressure on the demand for money, an upward pressure on interest rates, at a time when unemployment is still very high and very damaging for us to look at, that will be the test to see whether or not the Federal Reserve will allow again interest rates to move up, and perhaps if necessary move up fairly sharply, even though that will appear to many to be an awkward time to do it.

If they will do that, and I certainly hope that they will, then I think the long-run outlook for inflation from the point of view of monetary policy is substantially improved. If they give up, if they temporize, if they say, "Well, just this once we'd better kind of watch out what happens to interest rates because we don't want to aggravate the recession or whatever," then we'd be right back on the old paths we used to follow with such little success.

Two other comments, Mr. Chairman. First, I would like to emphasize that in our view—and I keep slipping into saying "in our view," reflecting the former views of the Federal Reserve Bank of Minneapolis—whether it's now the current views, I don't know—but at least my view and I know the view of many of us who worked on it together was that if the Federal Reserve will follow a consistent monetary policy, one which slowly but surely does restrain the growth of money, that it can take inflation out of the system without large costs in terms of increases in unemployment or lost output, and I think it's important from our point of view at least to understand that when we talk about having a restrictive or restraining monetary policy we do that without being insensitive to very real needs of those who are unemployed. In fact, in our view, it's only by that kind of policy that we can have the kind of long-run, viable and fully employed economy that we all seek.

Second and last, on the issue of a tax cut, I must confess that that is my current greatest concern because I really think for the moment the monetary policy is on a track that will help take inflation out of the system. I am concerned that in its enthusiasm and exuberance the Congress could undo a substantial portion of that. I have now been convinced by the staff with which I worked with for 3 years that in the current environment, if the Federal deficit increases, that is the analytical equivalent of printing more money and, therefore, if you want to reduce taxes you have to reduce real taxes, and real taxes are the amount of money which the Government spends because that represents the amount of goods and services which the Government extracts from the private income stream.

If you're unwilling to reduce spending but simply reduce tax rates, then you simply substitute the implicit tax of inflation for the explicit tax that you have reduced, and I think inflation is a very insiduous and undesirable tax and if we are unwilling to

reduce spending, then it seems to me we ought not to reduce the tax rates because the consequences of that will simply be an enlarged deficit and an ever-higher rate of inflation.

With that, I have used up my 10 minutes, Mr. Chairman, and I will stop and respond to any questions.

[Complete statement follows:]

STATEMENT BY

MARK H. WILLES

Executive Vice President & Chief Financial Officer

GENERAL MILLS, INC.

It is a great pleasure to testify before this Committee. With portions of the states of Wisconsin and Michigan included in the 9th Federal Reserve District, as President of that Federal Reserve Bank, I always felt proud to claim Senators Proxmire and Riegle as two of my "constituents." And having been born and raised in Utah, and in order to be bipartisan, I'd be delighted to adopt Senator Garn, but he may want to hear what I have to say before he gives the go-ahead.

As a former participant in the formulation of monetary policy, I appreciate this opportunity to share with you my views on the appropriate course of monetary policy. And I thought that I would do that within the context of the report issued by this Committee after its oversight hearings last February 25 and 26.

In that report you made seven recommendations, the vast majority of which I found highly desirable, and which I will use to help focus my discussion.

Recommendation 1 - The Federal Reserve should limit the growth of money and credit in a firm and stable manner.

Holding aside the question of credit growth, which I will discuss below, the implementation of this recommendation is absolutely essential if we are ever to gain control over inflation. There is almost universal agreement that in the long run, inflation is a monetary phenomenon -- that is, it can only continue if "money" is growing too rapidly. What is not so widely recognized is that firm control of monetary growth can reduce and eventually eliminate inflation without causing large increases in unemployment and big losses in economic output. The oft-heard estimates of the costs of fighting inflation by the use of monetary restraint simply are not credible.

For example, to reduce inflation by one percentage point, according to some sources, we must sacrifice $200 billion in real GNP. This implies that in order to reduce inflation from 18 to 11 per cent per year, we cut GNP to zero -- hardly a plausible relationship. Conversely, these estimates imply that for each point we add to our inflation rate, we will add $200 billion to real GNP. If that relationship were even remotely correct, we would have seen far greater increases in real GNP the last several years than in fact has been the case.

Pioneering economic research done at the University of Chicago, the University of Minnesota, the Federal Reserve Bank of Minneapolis and elsewhere, is providing increasingly strong support for the notion that if monetary growth is reduced slowly but persistently, inflation can be taken out of the economy with very little negative impact on output or unemployment. In fact, I believe that as the costs and uncertainty associated with inflation came down, output and employment would actually be higher than they otherwise would be.

Recommendation 2 - Multi-year objectives for a gradual but steady slow-down in monetary growth should be adopted by the FOMC.

This recommendation is a fundamentally important companion to the first one. If reductions in monetary growth are to reduce inflation without precipitating a sharp drop in output, they must be made slowly but persistently. They must be persistent so that policy is credible. They must be made slowly so that people have a chance to adjust their thinking and their economic plans. For example, if people have made commitments based on the assumption (which has been a very reasonable one) that inflation will continue at high levels, a sharp decline in monetary growth will cause an unnecessarily sharp retrenchment as there is no longer enough money to finance all of the transactions that are planned.

On the other hand, if monetary growth is reduced slowly, people will have time to scale down the dollar value of their commitments at approximately the same pace that inflation declines, so that while the dollar value of economic activity will decline, real GNP need not.

The Federal Reserve has always been very reluctant to set long-run monetary targets. The feeling has been that such long-run targets would hamper the Fed's flexibility in responding to a constantly changing economic environment. Unfortunately, in my judgment, the costs of such flexibility far exceed the benefits. We have made millions of computer calculations and spent bushels of money, and yet we still don't know very well how to use monetary policy to fine-tune the economy. In fact, since economic decisions are made by real people rather than machines, it now seems increasingly clear that the very act of economic intervention causes people to respond and change in such a way that they virtually eliminate the hoped for positive effects of changes in policy. Instead, we are left with some very undesirable side effects including inflation and increased economic uncertainty.

While a consistent, long-run path for monetary policy would not guarantee entrance into economic heaven, it would eliminate the major uncertainties and disruptions that have been caused in the past by "flexible" and often sharp changes in policy. While the world would still be an uncertain place, subject to ups and downs caused by all sorts of things, it would be a little less uncertain if government policy were more stable and therefore more certain. That could turn out to be a rather major accomplishment.

Recommendation 3 - The target ranges for the growth in the monetary aggregates should be narrowed.

The recommendation is an important correlary to the previous one. The smaller the range within which the aggregates are allowed to fluctuate, the better people will know what policy will be and therefore the better able they will be to plan ahead. The better people are able to plan ahead, the more likely they will be to make those saving, investing and consuming decisions that are essential to a healthy and growing economy.

Recommendation 4 - The FOMC should pay more attention to credit availability and establish a range of growth for a credit aggregate target available as part of its policy objective.

I'm sorry to say I disagree rather strongly with this recommendation. There are three problems associated with it.

First, there is no well developed theory that links credit aggregates to economic activity in a useful way. Credit growth seems to be more a reflection of what is going on in the economy than it is a tool that can be manipulated to influence what goes on in the economy in a systematic and predictable way. And if there is no well developed theory to guide you, then there is no way of really knowing how to set aggregate targets for credit aggregates.

The second problem with using a credit aggregate is that it further muddies the water as to exactly what monetary policy is. The Federal Reserve already has several monetary aggregates which it uses as policy targets.

In the short run, at least, they often move in different ways. These differences make it difficult for the Fed to know exactly what to do, and for Fed observers to figure out what the Fed is doing. Adding a credit aggregate target would simply compound these problems. In the long run, monetary policy is likely to be more consistent and more effective, the fewer the aggregate targets that the Fed tries to achieve.

Third, elevating the use of a credit aggregate increases the temptation of using things like credit controls to make sure that credit is not growing too rapidly. Credit controls tend to be quite discriminatory and counter-productive as policy tools, and I wouldn't want to see anything that would add to the impression that they might have some usefulness.

Recommendation 5 - The October 6 changes for implementing policy are appropriate.

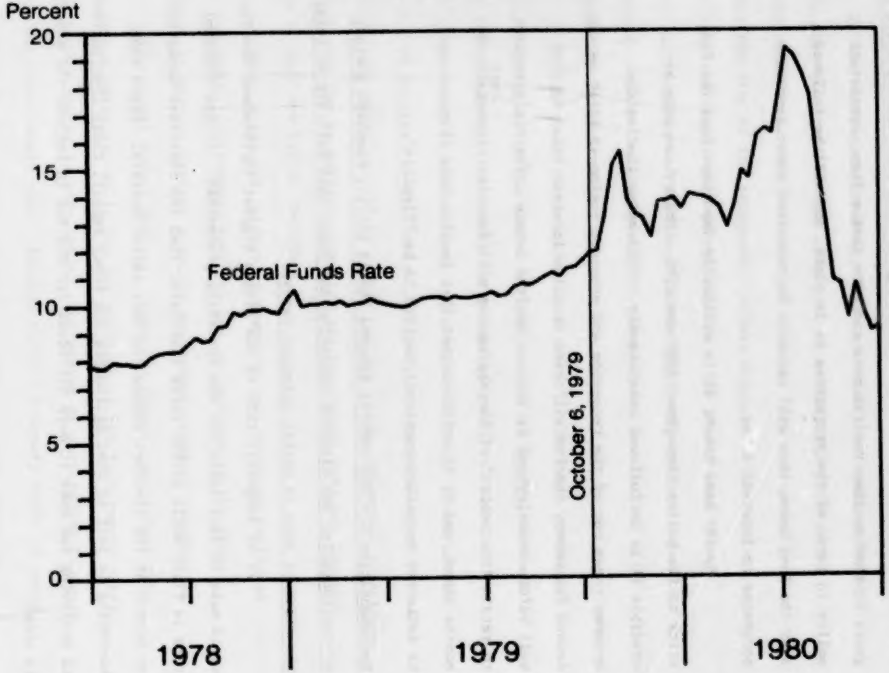
The Federal Reserve should be applauded for the policy it adopted last October by focusing more on controlling monetary aggregates and less on controlling interest rates. There is now a substantial body of literature that indicates that this shift in policy should lead to less inflation, and as inflation lessens, large swings in interest rates will also be reduced.

In the short-run, of course, adhearing to aggregate targets will cause interest rates to be more volatile. The chart shows the dramatic movements in interest rates since last October. Over time, however, these sharp swings should moderate as inflation cools and the economy becomes more stable.

It is important to recognize that the new operating procedures adopted by the Fed must be followed persistently for a long period of time for the reasons mentioned earlier. That is why I have been willing to see

Short-Term Interest

Weekly, mid-1978 to mid-1980



interest rates drop so sharply as the economy weakened, even though such declines have made some of our foreign friends nervous. My guess is that as they realize more and more that a firm, consistent policy in terms of the aggregates is in place, and will be followed over the long term, they will cease to be concerned about temporary movements in interest rates.

By the same token, it is critically important that the Fed stick to its policy throughout 1980 and 1981. Policy can only be credible if it is followed consistently. This means that as the economy comes out of the recession and pressure begins to build on the demand for money, the Fed will have to allow interest rates to rise well before unemployment is down to desired levels. The Fed's resolve to retain firm control of the aggregates will face its biggest test in the months ahead, and it is critical that that resolve hold firm and not be deflected by well-intentional desires to be "flexible".

Recommendation 6 - The Federal Reserve should quickly complete a study of restructuring the discount mechanism and place high priority on tying the discount rate to market interest rates.

In my judgment, this is the single biggest improvement the Fed could make to facilitate its new operating procedures. If the discount rate is fixed while market rates fluctuate, then the incentive banks have to borrow at the discount window can vary rather sharply. Since bank borrowing is part of what determines the money supply, these fluctuations in borrowing can make it more difficult for the Fed to control the growth in money.

Recommendation 7 - The Federal Reserve should not be expected to control inflation without assistance from fiscal policy.

In the current environment, this last Committee recommendation may be the most important of all. The air, as well as the press, is filled with talk of tax cuts. Some argue that tax cuts are needed to help reduce the size of the recession. Others argue that tax cuts are needed to help the supply side of the economy. I'm afraid that these two forces will combine and produce a tax cut that will neither moderate the recession or help the supply side of the economy, but instead will simply aggravate inflation.

It is important to recognize that the real tax which government imposes on the economy is the amount of money which its spends, because it is that spending that represents the amount of goods and services which government uses or takes out of the economic stream. Consequently, the only way to cut real taxes, (which I think it is very important for us to do), is to cut spending. If we simply cut tax rates, we merely substitute an inflation tax for an explicit tax, for the government must pay for the resources it uses one way or the other.

In fact, a tax cut, without a spending cut, produces inflation in today's economic environment just the way an increase in the money supply does. A tax cut without a cut in government spending requires an increase in the annual budget deficit. When the federal government runs repeated annual deficits, as it has for nineteen of the last twenty years, it simply prints and sells more bonds. The amount of outstanding Treasury bonds thus increases every year. Because today's Treasury bonds at maturity will be replaced by other bonds and never retired, they are essentially unbacked -- they are merely promises to deliver currency in the future. In every important way, in fact, they are just an alternative form of currency. Like currency, they are pieces of paper backed by nothing -- not by gold, not by tangible assets, not by future taxes. Like currency, they are fiat paper, paper that has value only because the government has so declared. Unbacked bonds are, in all essentials, part of our ever-expanding money supply.

Consequently, with more paper bonds pursuing a certain amount of goods, it takes more paper to buy the goods. The value of the paper declines; the price of goods goes up. Because bonds issued to finance deficits have become a form of money, the average price level will inevitably keep rising as long as the United States follows a policy of running continuous deficits. A balanced budget, then, is as necessary as firm Fed control over the monetary aggregates for stopping the rapid money growth that causes inflation. And like monetary policy, firm control of fiscal policy need not have large costs in terms of output or unemployment.

The CHAIRMAN. Thank you very much, Mr. Willes. Mr. Parry.

STATEMENT OF ROBERT T. PARRY, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, SECURITY PACIFIC NATIONAL BANK, LOS ANGELES, CALIF.

Mr. PARRY. Mr. Chairman and members of the committee, I am pleased to have this opportunity to present my views to this committee concerning the economic outlook, monetary policy, and related matters.

More specifically, I plan to comment on the performance of the economy in 1980 in some detail. Then, I shall review recent stabilization policies, both fiscal and monetary. Third, I intend to discuss prospects for the economy in 1981. Finally, I would like to comment on policy options for the 1981 economy.

THE ECONOMY IN 1980

According to the National Bureau of Economic Research, the U.S. economy has entered its sixth month of recession. In all likelihood, this business contraction will eventually be described as a severe recession, second only during the postwar history to the 1973-75 recession in terms of severity. This downturn probably will continue through the remainder of this year, producing a 3.9-percent peak-to-trough drop in real output. As shown in table I, this falloff will be substantially less than the 5.7-percent decline in the last recession but will greatly exceed the average decline for the first five postwar recessions.

In some respects, this recession will be more severe than the last one. Real final sales and, specifically, consumer spending, will be hit harder than the last time around. Inventory liquidation will play a minor role in this downturn, in contrast to the prior recession. This recession probably could be categorized as a "frontloaded" downturn, with the steepest drop in real output occurring in the first full quarter of the contraction. But, with only one of the projected three quarters of the recession in the record book, the risk is high that rising unemployment rates will produce a downturn that is steeper than the forecast 3.9-percent drop and is longer than three quarters.

In addition to the projected annual decline of 1.5 percent in real GNP, as shown in table II, 1980 will record many other dismal economic milestones. Consumer prices are expected to average 13.8 percent above last year's level, the steepest rise since 1947. The first quarter showed prices increasing at the fastest rate of the postwar period, a factor that cut deeply into consumer purchasing power and, thereby, aggravated the contraction. Granted that the first-quarter rise in consumer prices was overstated, other measures of inflation, notably the GNP price deflator and the deflator for personal consumption expenditures, accelerated in the first quarter, and for the year will show a rise over 1979's already bad price performance.

Energy prices, notably for imported petroleum, have been widely blamed for the surge in inflation. However, a steady rise in consumer price inflation since 1976 occurred despite the generally declining trend in the real price of imported oil during the 1976–78 period. A disappointing record on productivity and stimulative policies are largely to blame for the highly inflation-charged environment. With productivity declining since early 1979, and likely to decline through 1980, sustained progress in bringing down the underlying rate of inflation may be difficult to attain. Nonetheless, inflation news in the second half of this year will make for more pleasant reading than in the first half, largely due to the recent drop in mortgage rates and the moderating influence of the recession.

The rate of unemployment has skyrocketed in recent months after maintaining an historically high plateau at the end of the recent economic expansion. The second half should experience further cuts in employment, with sales declines and inventory liquidation pushing the jobless rate above the 9-percent peak that was reached in the last recession.

The drop in real retail sales from February through May exceeded the decline that occurred over 22 months during the last recession. Disenchantment with the fuel efficiency and price of new cars resulted in a near halving in the domestic car sales rate since the beginning of this year. Efforts to reduce consumer borrowing—partly promoted by the imposition of credit controls—adversely affected sales of most retail items. Homebuilding activity fell sharply in response to record high mortgage and home costs, and the resultant inability of many potential homebuyers to qualify for mortgage loans produced a steep drop in home sales and an overhang of unsold homes. Some factors affecting home and retail buying have improved recently, suggesting that the nadir in these sectors occurred in the second quarter of 1980. Any recovery in consumer spending and homebuilding during the second half, however, will be tempered by the consumer's efforts to build a savings cushion, by high and rising rates of unemployment, and by a pickup in food price inflation.

Capital spending is beginning to respond to the economic downturn, with orders for capital goods falling in response to declining operating rates and corporate earnings and to historically high financing costs. Although inventories have been relatively lean compared to sales, recent sharp sales declines are producing an unintended buildup in inventories. Efforts to liquidate inventories should result in second-half declines in industrial output and employment. Meanwhile, a deteriorating economic picture abroad is beginning to trim the demand for U.S. exports—a sector that previously was viewed as a potential source of strength to the 1980 economy.

Credit conditions generally mirrored the pace of first-half economic activity. The rapid acceleration of inflation during the first quarter and concerns over possible restrictions on credit availability led to a surge early this year in demand for business loans, notably short and intermediate term credit. Record high interest rates contributed to a first-quarter slowdown in borrowing for homes and consumer durable goods purchases. In response to the sharp drop in economic activity, credit demands weakened substantially in the second quarter, and interest rates fell precipitously. An exception to the slowing credit demand in the second quarter was the pickup in long term corporate financing, and a drop in long term interest rates encouraged businesses to pay back high-cost, short term debt with longer term financing.

Lending activity should begin to rise gradually in the second half, due, in part, to the recent declines in interest rates that are encouraging home sales and to the removal of credit restrictions that should temper the liquidation of consumer debt. Increases in borrowing, however, should be gradual, as high unemployment rates instill caution in consumer borrowing plans, and as inventory liquidation reduces the demand for short term corporate borrowing. Additionally, a restructuring of corporate balance sheets may prop up the demand for intermediate and long term financing at the expense of short term business credit.

PAST STABILIZATION POLICIES—FISCAL POLICY

A review of stabilization policies in recent years indicates that both fiscal and monetary policies have played important roles in the present economic situation. As an economic stabilization tool, fiscal policy can be viewed from a number of perspectives. Three popular ways of reviewing the recent course of Federal policy are in terms of the unified Federal budget, the high employment budget, and Federal outlays as a proportion of the Nation's output of goods and services.

The unified Federal budget has been in deficit 19 out of the past 20 years, with red ink totaling more than $400 billion—an amount equal to nearly half of the current total U.S. public debt of about $875 billion. More than half—$248 billion—of that $400 billion occurred between fiscal years 1976 and 1980, assuming the deficit for fiscal 1980 will approximate $60 billion.

In recent years, the unified Federal budget has not provided a complete description of the growing bulge in debt originating in the Federal sector. Since 1971, the role of off-budget outlays has increased significantly, with net outlays by nonbudget entities totaling $56 billion between fiscal years 1976 and 1980—an amount equal to about one quarter of the aggregate budget deficit over the same period. Combining net off-budget outlays with the Federal budget deficit, total Federal outlays have outstripped receipts by more than $300 billion between 1976 and 1980. This record of persistent deficits, particularly in times of prosperity, is an important element in understanding recent U.S. inflation problems.

Most economists question the use of the unified Federal deficit as a measure of economic stimulus or restrictiveness. The unified deficit can be a misleading indication of fiscal policy because it also reflects the effects of cyclical changes in economic activity. In contrast, the high-employment budget may provide a better perspective on fiscal activities. During the past business expansion, the high-employment budget was in deficit in every year between fiscal 1976 and 1979 and was in deficit during the first two quarters of the current fiscal year. Thus, by either measure—net outlays of budget and nonbudget entities or on a high employment basis—fiscal policy was overly stimulative during the past economic expansion.

An issue related to the high employment budget discussion is the question of what should be the assumed full employment unemployment rate (FEUR). Current official estimates place the FEUR at about 5.1 percent. There are many economists, however, who conclude that a more realistic estimate of the FEUR is closer to 6 percent than to 5 percent. An obvious implication of assuming a higher number for the FEUR is that fiscal policy has been even more stimulative than is indicated by official estimates of the high-employment budget.

A third way of viewing the recent course of fiscal activities is in terms of Federal outlays as a proportion of the Nation's gross national product. From fiscal 1960 to fiscal 1976, the proportion of Federal outlays on a national income accounts basis to GNP trended upward from 18.4 to 22.9 percent, but it then fell steadily to 21.3 percent in fiscal 1979. During this fiscal year, the recent trend is being reversed dramatically, and the proportion should approximate 23 percent. In addition, the sizable increase in Federal outlays in fiscal 1980 will provide a large base for fiscal 1981, and in spite of recent attempts to trim that budget, the proportion should reach 23.7 percent—the largest in the postwar period.

While the analysis of Federal outlays to GNP does not directly provide information on how restrictive or stimulative fiscal policy has been, it does illustrate a concern shared by many economists. A persistent growth in the size of Federal outlays relative to the rest of the economy is viewed by many as a threat to the private sector and also as a factor contributing to inflation and the slow growth in productivity.

MONETARY POLICY

Judged by growth rates of the monetary aggregates and bank credit, monetary policy was too stimulative during much of the past expansion. As indicated in table III, the aggregates and bank credit grew rapidly as the economy moved closer to a full utilization of its resources. In retrospect, it seems clear that the Federal Reserve should have more assiduously pursued slower growth rates of the aggregates and credit in the 1977-79 period and that failure to do so is a contributing factor to the inflation problem.

The Federal Reserve's actions on October 6 were a decisive move toward restrictiveness. The increase in the discount rate from 11 to 12 percent and the establishment of a marginal reserve requirement of 8 percent on managed liabilities of member banks, Edge Act corporations, and U.S. agencies and branches of foreign banks produced great changes in financial markets. Nominal and real interest rates rose strongly, and seasonally adjusted business loans trended downward throughout the fourth quarter. As measured by M-1B, the monetary aggregates grew more slowly in the fourth quarter and slowed further in the first quarter of this year.

The most significant Federal Reserve action of October 6 was the shift in focus from controlling interest rates to controlling bank reserves in order to "provide greater assurance that the committee's—FOMC—objectives for money growth could be achieved."[1] This shift in approach is desirable for at least two reasons. First, the Federal Reserve often had encountered difficulties in achieving stated aggregates targets under the old operating procedures. For example, throughout much of 1979, monetary growth "had exceeded the rates expected despite substantial increases in short-term rates."[2] Thus, by controlling reserves more directly, the Federal Reserve is likely to be more successful in reaching the FOMC's objectives for monetary growth.

The second reason that the shift in approach to controlling the aggregates is desirable and is probably more significant than the first. Prior to October 6, actual achievement of the monetary targets was of lesser importance to the Federal Reserve than it is today. Admittedly, targets had been stated publicly since 1975, but interest rates often were not permitted the flexibility to achieve the targets for the aggregates. The lower order of importance accorded to achieving these targets is illustrated by the procedure followed prior to 1979 whereby the base for the targets was shifted as actual numbers became available for the prior quarter.

Ascribing a more central role to the monetary aggregates obviously is not going to solve the stabilization problems of the monetary authorities. The Federal Reserve will still have to take a comprehensive approach to policy, looking at much more than the monetary aggregates. It would seem, however, that chances of reaching the ultimate objectives of stablilization policies have increased with a more central role accorded to the monetary aggregates.

An often-stated criticism of the shift in policy focus is that it will lead to greater volatility of interest rates. Interest rate developments since October 6 are held to be an example of this point. Granted, interest rates have become more volatile, but greater fluctuations in interest rates would seem to be a small price to pay for success in reaching the ultimate objectives of monetary policy. Also, the heights reached by interest rates in the recent past were not a result of the shift in policy focus, but rather they were the result of many other factors, importantly including record high rates of inflation.

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[1] Record of Policy Actions of the Federal Open Market Committee, meeting held on Oct. 6, 1979, "Federal Reserve Bulletin," 65, No. 12, (December 1979), p. 974.

[2] Ibid., p. 974.

With the benefit of hindsight, the credit policies adopted as part of the President's March 14 anti-inflation program were a mistake. We now know that the psychological and real effects of the program, particularly on the consumer, were massive and that they added considerable downward momentum to an economy that had already peaked in January. Virtually all financial and economic statistics dealing with the March through June period provide a consistent picture of the economy in one of its steepest 3-month slides in the postwar period. Illustrations of this point are found in statistics for housing starts, auto sales, and consumer credit.

Even without the benefit of hindsight, it appeared to many economists at the time that the March 14 credit policies were in error. The consumer's appetite for credit was already waning. Moreover, the sizable increases in interest rates that preceded March 14 would have taken the steam out of future business demands for credit. Finally, to those who believe that the monetary authorities have shouldered an inordinate share of the burden of combating inflation in relation to the fiscal authorities, the March 14 credit policies made that burden fall even more unfairly on the Federal Reserve.

March 14 is a good illustration of a textbook problem associated with monetary policy. Monetary policies must be given time to act, and also they must lead the target by many months. Unfortunately, the actions taken prior to March 14 were not given sufficient time to affect the economy. Also, the March 14 credit policies were not a response to what the economy was likely to be doing 6 or 12 months ahead. Rather, the actions were the response to a clamor from many sources to do something because inflation had "got out of hand" and financial markets were "chaotic."

Attempts to fix blame for March 14 are not productive. Almost all sectors of the economy have to share in that blame. A case can also be made for downplaying the responsibility of the Federal Reserve in instituting these actions, since it appears that the monetary authorities were a reluctant partner in the March 14 anti-inflation program.

PROSPECTS FOR THE ECONOMY IN 1981

The recent fall in interest and inflation rates should continue during the second half of 1980 but at a substantially more moderate pace than during the April-May period. This reduction in price and financial pressures should help to induce an economic recovery in 1981. An additional boost to the 1981 economy is based on the assumption that tax relief will be effective by early next year. Despite the tax cut, the drop in interest costs, and the easing in inflation, the 1981 recovery is likely to be the most sluggish upturn of the postwar history. Table IV compares the first-year performance for the projected 1981 recovery with the experience following the 1975 recession and the average upturn during the first year of the initial five postwar expansions.

Notable areas of weakness in the 1981 upturn will be consumer spending and State and local government purchases. Both sectors should be adversely affected by sustained efforts to trim budgets and rely less on credit during a period of constrained income/revenue growth. The expected sluggish recovery in capital spending has its precedent in the last recovery, when declines in business spending continued well after the trough in general economic activity. On the more positive side, the 1981 recovery in homebuilding will be one of the sharpest rebounds of the postwar period, while the growth in Federal Government purchases should greatly exceed the average gains for the previous recoveries.

Although consumer price inflation is expected to moderate in the months ahead, much of that easing results from the overstated influence of declining mortgage rates. the economic slump is lessening some of the demand pressures on prices, but, on balance, factors exist to place a high floor under a sustained improvement in inflation. As mentioned earlier, the productivity record in recent years has been dismal. A gradual recovery and a generally slow rise in employment should produce a gain in productivity next year following 2 years of declines. Employee compensation costs, however, are likely to advance at a relatively rapid pace, reflecting the scheduled rise in social security taxes and some attempt by workers to achieve an increase in real wages after many years of declining real earnings. Thus, although unit labor costs for nonfinancial corporations should increase in 1981 at a lower rate than this year's over 10.5 percent rise, the projected increase of about 9.5 percent in these costs will build in substantial cost pressures. Additionally, food prices will not be a moderating influence on inflation as they were in early 1980. Rising home prices and the decontrol of domestically produced petroleum and natural gas will also lead to a trend of rising inflation rates in 1981. Overall, consumer prices are expected to increase 9 to 10 percent next year.

The anticipated sizable rise in consumer prices will be a factor that will retard the recovery in consumer purchasing power. In addition, although employment should increase with the recovering economy, the jobless rate is projected to average 8.8 percent next year—a sufficiently high level to instill caution in consumer buying plans and contribute to steady increases in the personal saving rate. Although the new 1981 model cars promise increased fuel efficiency, the recovery in car sales next year should be modest, as consumers continue to reduce their existing debt burden. On balance, inflation, unemployment, and a high debt burden will cast a pall on buying plans next year, thus limiting the rebound in the sales of durable goods and other deferrable items.

Capital spending in 1981 should suffer from the effects of relatively high rates of inflation and long-term financing costs as well as from 2 years of declining corporate earnings. Corporate profits from current production are projected to decline 6.5 percent next year following a nearly 17 percent drop in 1980. This squeeze on profitability should force companies to rely increasingly on external sources for their financing, and thus will discourage some capital spending plans. Although business tax breaks should result in a pickup in capital spending activity late next year, steady declines in real spending through the midyear should make capital spending one of the weakest sectors of the 1981 economy.

Homebuilding, conversely, should post a sharp rally next year. The underlying demand for housing is quite strong based on age group and population trends, while the inflation-hedge and tax-break benefits of housing should continue to stimulate the demand for homes. Additionally, low rental vacancy rates and limited housing availability in many areas of the country should mean that a pickup in home sales will quickly translate into increases in new building.

Credit demands should rise with the recovering economy, notably with the impressive recovery expected in the housing area. Inventory rebuilding will follow the gradual rise in consumer and capital spending, while increases in defense spending will also increase inventory requirements. The demand for short-term business credit should increase in 1981, in contrast to the drop in loan demand during the recession of 1980. The demand for long-term corporate financing, however, should slow, reflecting the completion of most of the corporate balance sheet restructuring and the generally sluggish activity in capital spending. The rise in credit demands, notably short-term credit, and an expected increase in the rate of inflation should cause the cyclical low in interest rates to occur in early 1981. Based upon the sluggishness of the 1981 upturn, however, the rise in short-term rates over the course of next year could be limited to between 100 and 150 basis points. The increase in long-term rates may be on the order of 50 to 75 basis points.

FUTURE STABILIZATION POLICIES—FISCAL POLICY

During fiscal 1981 the budget is expected to be in deficit by about $58 billion—essentially the same as the $60 billion estimate for fiscal 1980. Receipts are expected to rise by $55 billion—10.6 percent—to $572 billion after rising 11 percent in 1980. The weak economy and $23 billion of an assumed $30 billion tax cut to be applied during the last 9 months of the fiscal year account for the anticipated slowing in receipts. It is assumed that two-thirds of the tax cut will benefit individuals, and the other third will go to business. budget outlays are expected to rise by $53 billion—9.2 percent—to $630 billion after rising 16.9 percent in 1980.

From my viewpoint, a tax cut of approximately $30 billion is an appropriate policy for 1981. Other taxes will be rising substantially as a result of the large increase in payroll taxes, the effects of inflation pushing taxpayers into high income tax brackets, and the impact of the windfall profits tax. Withut a cut in taxes, there is the risk of prolonging and deepening the business downturn. A strong case can be made that the tax cut should be designed primarily to encourage greater saving and investment rather than to stimulate consumption spending. Such a tax change could well provide less of a lift to the 1981 economy, but the longer-term need to stimulate saving and investment in an effort to encourage the growth of productivity is so great that the trade off would seem acceptable.

With regard to Federal Government spending, outlays on a national income accounts basis will total approximately $641 billion in fiscal 1981. Thus, relative to GNP, outlays would be up from 23 percent to 23.7 percent—the highest proportion since the Second World War. Even though much of the increase in the proportion is a cyclical phenomenon, such a development is discouraging. A serious program designed to reduce that percentage is imperative, and a longer-term objective of 21 percent or lower, which last occurred in 1974, would seem appropriate. In the shorter-term, efforts should be made to reduce the share to 22 percent by fiscal 1982.

In formulating monetary policy for 1981, the monetary authorities are in a particularly difficult situation. Members of the Federal Open Market Committee are required to strike a balance between the short-run, countercyclical objective of stimulating the economy following a severe recession and the long-run objective of significantly reducing the rate of inflation. Furthermore, this balance must be struck in a year of significant changes in financial institutions.

If a reduction in the trend rate of inflation is to remain the Nation's highest economic priority—as I believe it should—the long-term policy of the Federal Reserve should include a publicly-stated plan to reduce the growth rates of the monetary aggregates. in setting monetary growth targets for 1981, however, the monetary authorities will also be faced with the added responsibility of not prolonging the recession or aborting a recovery.

Participants in both domestic and international financial markets will be focusing on the Federal Reserve's policy regarding growth targets for the aggregates as an indication of the resolve of the monetary authorities in continuing the battle against inflation. In addition, as this committee knows, 1981 will be a year of significant continued financial evolution. Negotiable orders of withdrawal—NOW accounts—will become available nationwide on January 1. The extent of the effects of this financial innovation on the public's deposit holdings is unknown, but there is little doubt that the growth rates of the primary monetary aggregates will be affected. Furthermore, the Monetary Control Act of 1980 will bring about important changes in the structure of the U.S. financial system and is likely to affect the conduct of monetary policy.

Though the 1981 economy is expected to grow relatively slowly in real terms, a nominal growth on the order of 12 to 13 percent appears likely. Thus, it would seem that in 1981 the Federal Reserve has little latitude to reduce target ranges for the monetary aggregates below 1980 levels. For example, if velocity were to grow as rapidly as it did in the first year of recovery following the last recession, it would indicate a growth rate of M-1B within the current target range of 4.5 to 6 percent. The 7.6 percent increase in velocity that occurred then, however, was very large, far surpassing the growth in velocity that followed the 1960-61 and the 1969-70 recessions. Moreover, if the introduction of nationwide NOW accounts leads to a more rapid growth of M-1B, as individuals convert some of their interest-bearing financial assets into interest-bearing transactions accounts, chances are that growth rates as low as the present target range for M-1B would be difficult to achieve.

CONCLUSION

This review of the economy and stabilization policies suggests that an essential factor in the acceleration of inflation in recent years has been fiscal and monetary policies that were too stimulative. On the positive side, it appears as though solving the inflation problem has been elevated to the top of the list of national economic priorities. To date, however, rhetoric has been more plentiful than actions designed to lower to rate of inflation. As far as fiscal policy is concerned, there are only one or two relatively minor examples of where anti-inflation rhetoric has been translated into effective action, notably in the area of deregulation. More encouragingly, the monetary authorities have changed their operating procedures in a way that could prevent excessively stimulative policies in the future. But, even in this instance, the time since the change in operating procedures has been short, and the resolve of the Federal Reserve to persist with restrictive anti-inflation policies has yet to be tested.

Five years from now, this committee presumably will review the inflation performance of the first half of the decade of the 1980's relative to the dismal performance of prices during the past decade. If that review is not satisfactory to the committee, blame for the inflation performance of the economy is likely to fall where it does today—on the failure of stabilization authorities to chart and to follow diligently a course designed to reduce the rate of inflation.

[Tables accompanying Mr. Parry's statement follow:]

TABLE I.—THE ECONOMY IN RECESSION—PEAK-TO-TROUGH PERCENTAGE CHANGE

[Constant 1972 dollars]

	1980 1st quarter to 4th quarter[1]	1973 4th quarter to 1975 1st quarter	Average for first 5 postwar recessions
Gross national product	−3.9	−5.7	−1.5
Consumption	−3.2	−1.1	.7
Investment	−15.4	−36.4	−13.2
Business fixed	−7.4	−11.1	−8.9
Residential	−28.4	−32.8	+4.4
Government	−.2	+2.9	+1.0
Federal	.2	+1.7	−4.0
State and local	−.5	+3.6	+7.7
Final sales	−3.5	−2.2	−.2

[1] Forecast.

TABLE II.—1980–81 U.S. ECONOMIC OUTLOOK

[Billions of dollars]

	1980[1]	Percent		1981[1]	Percent	
		Change	Change 4th quarter 1979 to 4th quarter 1980		Change	Change 4th quarter 1980 to 4th quarter 1981
Gross national product	2,548.0	7.6	5.7	2,792.0	9.6	13.0
GNP (1972 dollars)	1,410.5	−1.5	−3.6	1,413.2	.2	3.3
Consumer Price Index (1967=100)	247.7	13.8	11.8	270.8	9.3	10.0
Unemployment rate percent	7.7		[2]8.9	8.8		[2]8.4
Corporate profits						
Operating	148.8	−16.9	−25.2	139.1	−6.5	17.8
Pretax book	223.6	−5.8	−17.1	194.1	−13.2	3.0
Personal income	2,103.6	9.3	7.9	2,310.8	9.9	11.8

[1] Forecast.

[2] Fourth quarter average.

TABLE III.—ECONOMIC CAPACITY AND GROWTH OF NEWLY DEFINED MONETARY AGGREGATES

	Real GNP[1]	M–1A	M–1B	M–2	M–3	Bank credit
1975	92.3	4.7	4.9	12.3	9.4	4.1
1976	94.9	5.5	6.0	13.7	11.4	7.7
1977	97.0	7.7	8.1	11.5	12.6	11.1
1978	98.3	7.4	8.2	8.4	11.3	13.6
1979[2]	98.1	5.7	8.8	9.2	9.9	13.6

[1] As a percentage of potential GNP.

[2] The index is based on an average of the 1st through 3d quarters; growth of the aggregates reflects growth from the 4th quarter 1978 to 3d quarter, expressed as a compound annual rate of increase.

Note.—

Growth of the monetary aggregates expressed as 4th quarter to 4th quarter percentage increase.

Potential GNP obtained from Data Resources, Inc.

TABLE IV.—THE ECONOMY IN RECOVERY—PERCENT OF CHANGE 1 YEAR AFTER RECESSION'S TROUGH

[Constant 1972 dollars]

	1980; 4th quarter to 1981; 4th quarter[1]	1975; 1st quarter to 1976; 1st quarter	Average for 1st five postwar recoveries
Gross national product	3.3	7.5	8.1
Consumption	2.3	6.6	5.6
Investment	14.5	26.2	36.0
Business fixed	1.0	2.0	10.0
Residential	32.7	26.2	24.6
Government	1.5	2.1	2.0
Federal	2.8	.2	.1
State and local	.9	3.2	4.6
Final sales	2.5	5.0	5.6

[1] Forecast.

The CHAIRMAN. Thank you, Mr. Parry. Dr. Sinai.

STATEMENT OF ALLAN SINAI, VICE PRESIDENT, DATA RESOURCES, INC., LEXINGTON, MASS.

Mr. SINAI. Well, I think this is a very appropriate time for a serious evaluation and review of monetary policy, especially given the severe recession in the economy. In fact, the first quarter of the recession is the deepest turndown since the 1930's. The severe credit crunch as a result of the extraordinary exercise in overkill by the Federal Reserve has to bear a good deal of the responsibility for the deep downturn that is now in process. Inflation rates, although very much lower than the 18 percent rates that were occurring earlier this year, are still in double digits. The unemployment rate is now up 1.7 percentage points from 4 months ago with 1½ million more people unemployed. The volatility of the U.S. financial markets in the last 6 or 8 months has been without precedent with interest rates moving up and down from 4 to 11 percentage points. Growth in productivity is down one-half a percent per annum since 1973 and was down 0.7 percent in the first quarter.

Really, these statistics show a dismal performance for a once proud U.S. economic machine, a combination of austerity and stagflation that should be of great concern and which constitutes a national crisis in economic policy.

What I would like to do in my oral statement is to talk about the near-term outlook for the U.S. economy and inflation, speak about the role of monetary policy over the last 6 to 9 months in a retrospective fashion and offer some judgments on it, then make some suggestions for the appropriate course of policy over the next year and a half.

SECOND WORST RECESSION

Considering first the U.S. economic outlook, we are set for the second worst recession in the postwar period which will likely last until early 1981. The DRI forecast suggests still rising unemployment into next year, another two quarters of no real economic growth, still severe inflation despite the weakness in the economy over the next 9 to 12 months, at best 8 percent on average, over the next year, continuing slow growth in productivity, and relatively high nominal interest rates according to historical standards for periods of slack in the economy.

Our current projection of the peak-to-trough decline of GNP is a little over 4 percent which would make it the second worst postwar recession, but very sharp for a recession that is projected to be about average length of some 11 months.

From the last quarter of last year to the last quarter of 1980, the drop is projected at 3.9 percent and then a pretty good rebound is in the forecast for the fourth quarter of 1980 to the fourth quarter of 1981. The rate of decline in the economy should be less steep in the second half of this year with only a modest rebound in the first half of next year. Even assuming a $30 billion tax cut a strong rebound in the U.S. economy does not appear to be in the cards until the second half of 1981.

Despite the relatively severe downturn, no relief on inflation far below double digits can be expected. Even after 2 years of sluggish real economic growth, an annual rate of decline at 1.7 percent this year, and a rebound of 1.3 percent in 1981, most inflation rates would still be ranging between 8 and 9 percent.

By late this year, the implicit GNP deflator might get down to as low as 8 percent or so. We are looking for considerable improvement in consumer prices from the fourth quarter of 1979 to the fourth quarter of 1980. Our projection is a high 12.2 percent, but from the fourth quarter of 1980 to the fourth quarter of 1981 the order of magnitude would more likely be 8 percent. Even at these rates or a little less, the gains on inflation from the recession have to be described as disappointing because we come out of a severe recession with inflation rates at a plateau that are considerably higher than anything we have seen before. Monetary growth should fall short of Fed long-run targets in 1980. Our projections show M1-A to rise 2.4 percent over this year, from the fourth quarter of 1979 to the fourth quarter of 1980, which would be a considerable shortfall from the Fed targeted numbers.

We also look for M1-B to rise by less than what the lower limit of the Fed target range would show. We assume that interest rates will remain relatively high for a recession with the prime rate never getting lower than a trough of 9 or 9.5 percent in early 1981 and long-term bond yields remaining in a range of some 9.5 to 10.5 percent.

To achieve monetary growth on target for this year the Federal Reserve would have to ease monetary policy enough to lower short-term rates by another 3 or 4 percentage points and we just don't think they will do that. Instead, there will be acceptance of lower growth than is targeted in the monetary aggregates rather than a continuing acceleration of easing in monetary policy.

Let me add that although the recent data suggests some improvement for the economy in June, nobody should be misled about the depth of the weakness in the economy. This is a severe recession and the likely 9-percent unemployment rate by early 1981 will be the worst in history. The drop in real GNP in the second quarter——

The CHAIRMAN. Would you repeat that?

Mr. SINAI. The 9-percent unemployment rate that we are projecting for the first quarter of 1981 will be the highest unemployment rate in history, aside from the depression.

The CHAIRMAN. The highest unemployment rate in how long?

Mr. SINAI. Since the 1930's.

The CHAIRMAN. And you're predicting that will be when?

Mr. SINAI. The first quarter of next year.

Some rebound in the economy had to occur really in the early summer because the decline in February, March and April was so severe, so it was not surprising to see a modest upturn in consumer spending and housing starts in June. It would be surprising to see that kind of upturn sustained for more than perhaps another month or so and we do think real growth will continue to decline for the rest of this year.

Well, how did the U.S. economy get to this position? We'll get nowhere today reciting the history of the last few years of the difficulty of the U.S. economy. But over the current term, it was the severe oil and energy crunch on real income overextended debt position for households, a squeeze in real purchasing power because of a severe inflation, a restrictive setting for both fiscal and monetary policy in really an age of expansion, but what really drove the economy down as sharply as it has dropped in the second quarter was the financial factor in the business cycle, the same financial factor that we have seen in every postwar recession since the mid-1950's and undoubtedly the same cause and effect that occurred some 40-some-odd years ago in the depression era.

The necessity or the believed necessity of dealing with inflation by the central bank led to a very tough and tight monetary policy, especially beginning last October 6. Given the lags of how monetary policy affects the economy, the deep downturn in the second quarter came at about the right time, some 6 months after the beginning of the most rapid tightening of the Fed policy.

We believe that we had a severe, full-blown credit crunch that was little different in its nature than in previous years. Credit wasn't fully cutoff, but nevertheless, the crunch was severe, with its most severe implementation in the first quarter. Indeed, it occurred at the very time that the economy was moving into a recession. In fact, it occurred after the economy had dropped into recession in January.

It's now clear that the recession was in process at that time, the very time the central bank was engaging in the severest monetary restraint in this episode with the highest dose of overkill in February and March with the implementation in peacetime of credit controls. Had the Fed simply waited for the previous doses of tight money, including those of October 6, to work through the economy with the usual lags and recognized the temporary nature of a large part of that 18-percent inflation rate in January through March, the economy would have grown sufficiently weak rather than being propelled into this deep downturn. By tightening so sharply, the central bank policy actually was a major source of instability with the Consumer Price Index reflecting higher mortgage rates because of its curious way of calculating that in the inflation rates, and business loan demands accelerated for fear of credit controls. I think there is legitimate question as to the payoff on inflation from that severe restriction.

MULTIDIMENSIONED INFLATION

Will a recession cure inflation? I don't think the recession is likely to cure the current inflation or eliminate most of the permanent part of it. The first 7 or 8 percentage points of that 18-percent inflation rate really were easy and in fact might have dropped without the severe recession that we are having. If the inflation were primarily caused by excess demand, too many dollars chasing too few goods, then I would applaud the credit crunch and recession and say that it was very welcome medicine. However, the problem is that the current inflation is multidimensioned with a variety of causes that are not fully amenable to one type of policy. These causes of inflation are cost-push, shock-related, and demand-pull. The bulk of the current inflation is due to cost-push and shock factors rather than excess demand, and we have estimated that this core rate of inflation is running about 8 to 10 percent per annum, which now is mostly the inflation that's still there.

With so much current inflation of that core variety, tough demand policies are really doomed to failure, although restraint in fiscal and monetary policy is an important backdrop to effective long-run control of inflation. The policies of extreme restraint are really counterproductive so long as most of the inflation rate is due to another cause.

The Chairman. What was that? I didn't hear you.

Mr. Sinai. Most of the inflation is due to causes other than excess demand. Severely restrictive demand management policies, whether it would be raising taxes, cutting Government spending, or severely tight monetary policy, will not solve our inflation problem.

Well, in reviewing the performance of monetary policy I suspect I will part company with colleagues in my testimony today in giving monetary policy some rather bad marks for the last 6 months. I think the final results of the exercise of the new Fed policy have not differed much from what we have seen in the past and the results of the last 50 years of stabilization policy really cannot be pointed to with any pride.

Two statements that I remembered made some years ago apply very much today. They were made back in September of 1975 and May of 1973, and I might just review parts of them to indicate what the monetary policy dilemma is and why I think the Fed has pretty much failed this time around, just as in previous instances.

Back in September of 1975, I was commenting on current conditions:

> The recent unexpected burst of inflation highlights the dilemma of contemporary monetary policy. Higher prices, regardless of the origin, result in an increased transactions demand for money. Most estimates suggest a unitary elasticity of the demand for money with respect to the rate of inflation. Given a policy that is directed at achieving fixed rates of growth in money, inflation-induced monetary growth may exceed the targets set by the central bank.
>
> Monetary policy must then be tightened by draining reserves from the banking system; with subsequent increases for interest rates on Federal funds, U.S. Treasury securities, nondeposit liabilities, and eventually the prime rate.
>
> Economic expansion is slowed and the hope is that inflation will ease, but therein lies the fallacy in the current practice of monetary policy. The response of the economy to monetary restriction has been a reduction in the quantities of output and employment rather than falling prices, and as volume has dropped producers have charged higher prices to maintain profits, moving up the demand curve for a given product. The prime example of this phenomenon has been in the last two years where inflation and tight money caused the deepest recession since the 1930s, but failed to eliminate the worst inflation of the postwar period.

As you recall, 1973-75, a not totally dissimilar situation, brought us the deepest recession since the 1930's but failed to eliminate the worst inflation of the postwar period. At least at that time it was the worst.

> The tendency toward quantity adjustments and perverse price behavior in periods of lessened demand constitutes a fundamental structural change in the U.S. economy, complicating the task of monetary policy. The greater the degree of cost-push inflation, or price increases from external shocks, the more futile is the use of monetary policy as a tool of stabilization.

Those were comments made in September 1975. Back in May of 1973, analyzing the postwar history of monetary policy I noted that:

> The Federal Reserve overplayed its role in every episode by attempting to maintain a restrictive monetary policy for longer than was necessary. Yet, the monetary authority never intentionally sought to produce a crunch. Why did the Federal Reserve overstay its tight stance? The most likely answer is that the monetary authority probably did not appreciate the potency of monetary policy or have adequate knowledge of the lags between policy implementation and its effects. The central bank, in reacting strongly to contemporaneous signals such as inflation, maintained a tight posture for too long. It was difficult to ease up on policy prior to signs of significant economy slowdown and reduced inflation. Yet in order to avoid overkill, monetary policy, because of the lags, must turn before full proof of the success of earlier restrictive policy appears. Precisely the same possibility for error exists at this time if slower monetary growth is to be awaited as a signal of policy success. If monetary policy is kept tight until a time of substantially slower monetary growth, overkill will have been applied.

I do believe that happened this time. I also believe the same rule applies on the upswing, and this might refer to one of the questions you raised earlier. If the Federal Reserve becomes overstimulative while monetary growth is growing too slowly and they keep on pushing to make monetary growth grow too rapidly, they will sow the seeds of a too rapid expansion. So they should sit and watch and wait and let monetary growth grow at less than desired targets and await the effects of successive moves of easing.

So it isn't paradoxical for me to say the Fed should not ease any more at this time. It should simply wait and let the turn of interest rates and the easing of monetary policy over the last few months, affect the economy before making any other massive move. If the Fed goes too far at this time they will simply overstimulate the economy and we know that they did that a couple of times in the last 10 years too.

As I look at the provision of bank reserves and the use of the new monetary policy in the last 6 months the evidence suggests an extremely volatile policy. In February and March the Fed drained bank reserves at rates on the order of 15 to 25 percent. From late April to June reserves were added at rates of 30 or 40 percent. Between April and now, when interest rates first went up to 7 to 10 percentage points prime rate of 20 percent was reached in 3 months—the weak economy and aggressive Fed ease, more than erased those rises of interest rates. I would laud the Federal Reserve for quickly moving to an easier stance, but I can only look at the policy of the last 6 months with amazement. Stop-go monetary policy has been applied to an unprecedented degree both in terms of interest rates, reserves, and even monetary growth which has been bouncing up and down like a yo-yo for the last 6 months.

This leaves much to be desired and as I look at an economy that's dropping 9 percent in the second quarter and has inflation rate still at 10 percent, I certainly cannot react with any great optimism over the way monetary policy has worked.

Well, it's easy to criticize. It's the easiest thing in the world. What next for monetary policy? What would I suggest?

I think the proper stance for monetary policy during the rest of this year and into 1981 is conditioned by the current state of the economy, the very weak state of the economy, and the need to avoid repetitions of the same errors made in the past.

I would urge the following: First, that there be less volatility in the practice of monetary policy. Since the institution of the new Fed policy monetary policy has taken on more of a stop-go tone than had previously been the case. This is true in measure of growth of reserves, money, or in terms of fluctuations of interest rates. The danger is that monetary policy is becoming more of a contributor to instability than to stability.

NEW APPROACH TO POLICY

Greater stability could be achieved without abandoning the new approach to policy by stating more narrow ranges for allowable growth in unborrowed reserves and narrowing the bounds committed to the Federal funds rate. Although this would be a step backward for the new operating approach set then. Some modification seems appropriate given the considerable instability of financial markets in the economy since last October. With the new Fed policy far from a success, it is time to make some modifications that would not be an admission that the policy is not a good one. I was all in favor of operating on reserves rather than interest rates and my suggestions now simply are a modification in the way policy is implemented.

I would also urge more patience on the part of the central bank and everybody else in recognition of the lags before changes in monetary policy impact the economy. Had the central bank waited

1 or 2 months rather than moving toward severe restriction in February and March, the downturn in the middle two quarters of this year would have been mitigated considerably with virtually no cost on inflation.

The **Chairman**. Can you wind up in about a minute?

Mr. **Sinai**. I would also urge a lowering of the longrun monetary growth targets, but with the previous wide bands to retain flexibility to protect against external shocks. I think a 2.5 to 5.5 percent target range for M-1A and M-1B would be quite appropriate, would be consistent with a longerrun program of fighting inflation by the Fed, and given the weakness in the economy, would not be difficult to impose without damage to the economy for the next 2 years.

Finally, I would also urge the avoidance of too aggressive an easing in order to provide an appropriate demand management background for other stabilization policies. Throughout the decade of the 1970's, the Federal Reserve made the mistake of excessive easing almost as many times as overkill. So that even if in the near-term monetary growth is below Fed shortrun targets, too aggressive an easing should not be pursued because of the long lags in the effects of monetary policy.

[Complete statement follows:]

Monetary Policy for the Early 80s

by Allen Sinai*

A serious evaluation and review of Federal Reserve policy, as required by the landmark Full Employment and Balanced Growth Act of 1978, is particularly appropriate at this time. The U.S. economy has abruptly slid into the deepest downturn for the first quarter of a recession since the 1930s, to a large extent the result of an extraordinary exercise in overkill by the central bank. A severe credit crunch, the sixth of the postwar period, and unprecedented peacetime credit controls were imposed at the very time the economy was sinking into the recession, greatly intensifying the downturn already well in process. Inflation rates, though considerably lower than the 18% early this year largely created by the special factors of OPEC oil, energy and shelter costs, are still in double-digits. The unemployment rate has soared to 7.7% from 6.0% in just four months, with an additional 1.5 million persons unemployed since January. The volatility of U.S. financial markets has been without precedent, with interest rates moving up and down by a range of 4 to 11 percentage points since the end of 1979. Growth in productivity has slowed to 0.5% per annum over the past six years, and was down a large 1.7% during the first quarter. These statistics show a dismal performance for the once proud U.S. economic machine; indeed, an extreme stagflation that constitutes a "national crisis".

Although monetary policy is only one of the factors that has contributed to the sorry state of affairs in the U.S. economy, it is of particular importance. The effect of money and credit, sectoral flows of funds, interest rates, and stock prices on real economic behavior is massive and pervasive. One need only study the record on business cycles, where at least six instances of "credit crunches" have occurred in the postwar period alone that proved decisive in moving the economy into a recession, and expansionist monetary policy contributed to inflation.[1] And, with a virtual bankruptcy in the use of other stabilization policies, the role of monetary policy has loomed even larger. The failure of U.S. stabilization policy efforts is all too evident, manifested in progressively higher inflation and unemployment rates over the past fifteen years.

How deep is the current downturn likely to be and low long will it last? Will there be an inflation benefit commensurate with the cost of the present recession? How has monetary policy performed in the current episode? Has Fed policy been consistent with Administration goals for the economy? What is the verdict on the New Fed Policy instituted last October 6? What is the proper role for Federal Reserve policy now, given a much deeper cyclical downturn than was expected? What are the policy choices for the early 80s to improve the dismal record of the U.S. economy? And, what are the lessons to be learned from the past - the themes to be drawn for a better result in coming years?

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[1] DRI has made numerous studies of the flow-of-funds cycle in the U.S. economy, of which the credit crunch is an integral element. The latest analysis appears in A. Sinai, "Crunch Impacts and the Aftermath," Data Resources Review, June 1980, pp. 37-60. Other studies include A. Sinai, "Credit Crunch Possibilities and the Crunch Barometer," Data Resources Review, June 1978, pp. 9-18; and A. Sinai, "Credit Crunches - An Analysis of the Postwar Experience," in O. Eckstein, ed., Parameters and Policies in the U.S. Economy (Amsterdam: North-Holland, 1976), pp. 244-274.

In summary:

- The initial stage of the current recession is the deepest since the 1930s, to a large extent the result of the overkill in monetary policy that took place between last October and mid-March. The current DRI outlook is for a recession of near average length, some 11 months, but with a 4.2% peak-to-trough decline in real GNP making it the second worst downturn in the postwar period. The quick switching of monetary policy to an easier tone in recent months should help bring about a recovery by early 1981.

- It is now clear that the recession was in process at the very time the central bank was engaging in the most severe application of monetary restraint, with overkill through a huge draining of bank reserves during February-March and the imposing of unprecedented peacetime credit controls in mid-March. Had the Fed simply waited for the previous doses of tight money, including those of October 6, to work through the economy with the usual six-to-nine month lags and recognized the temporary nature of the shelter-oil oriented 18% inflation rates in January through March, the economy would have grown sufficiently weak rather than being propelled into the deepest initial downturn of the postwar period.

- The policy induced recession of 1980 is no "cure" for the severe inflation that is plaguing the U.S. economy. If the inflation were primarily caused by excess demand, then the credit crunch and recession would have been welcome medicine. However, the problem is that the current inflation is multi-dimensioned, with a variety of causes not fully amenable to a single type of policy. With so much of the inflation due to cost-push and shock factors, tough demand-management policies are doomed to failure in ridding the economy of a large part of the current inflation. Despite the relatively long and deep recession that is predicted, inflation rates will remain in a range of 8 to 10%, on average, for most of the next few years. Even at 7 to 8% by 1982, the inflation benefit from the current severe recession will hardly be commensurate with the costs.

- Monetary policy has performed badly in the current episode. First, an unprecedented degree of monetary restraint was applied at the very time the economy was sinking into a recession. Nonborrowed bank reserves were drained at 20 to 30% rates during February and March and interest rates rose from 3 to 7 percentage points. A full-blown credit crunch resulted, with severe financial instability for financial institutions, households, and the business sector. To make matters worse, credit controls were applied well after growth in consumer credit had dropped sharply. Second, monetary policy has followed an extreme "stop-go" pattern since the end of 1979. Almost immediately after the credit crunch the Federal Reserve reversed gears to more than erase the dose of restriction that had been applied in the previous six months. From late April to June, interest rates declined by up to 10 percentage points, with exceptionally rapid provision of reserves at 30 to 50% rates. Third, the central bank is not taking enough account of the lags for the impacts of monetary policy that have been well documented in scientific work. If only the Federal Reserve had waited one or two more months for the lags from the October 6 tightening to impact, a considerable portion of the downturn during the second quarter of 1980 might have been prevented with virtually no cost in extra inflation. While the Federal Reserve is to be lauded for quickly moving to a less restrictive state in the past few months, one can only look at the policy of the last six months with amazement.

- Fed policy has not been consistent with Administration goals for the economy, in that a deeper recession than desired has been induced with still near double-digit rates of inflation. Of course, it must be recognized that Fed policy alone cannot possibly produce results in the economy that would be consistent with the goals of any Administration. External shocks, ranging from unexpected rises in OPEC prices to drought effects on food prices, almost certainly will create severe problems for the successful implementation of monetary policy. Lack of coordination between Fed policy and other stabilization measures also make the role of the central bank very difficult, as do the international economic and financial considerations which are now much more important.

- The New Fed Policy of last October 6 cannot be deemed a success at this point. The dollar is weaker now against most other currencies, compared with October 5. A full-blown credit crunch and deep recession have occurred. The unprecedented volatility in the financial markets has complicated the orderly operation of transactions. Inflation rates have declined from the 18% peaks of the first quarter, but mainly through reductions in energy and food price inflation, elements that might have improved without the severe restriction that was applied earlier this year. The economy appears to have become less stable since the New Fed Policy. Monetary growth has eased, but for a time by too much, until recently, when another reacceleration began. The single notable success for the New Fed Policy has been in stemming the wild speculation in precious metals and commodities that had been in process.

- The proper course for Federal Reserve policy now is to move back toward a more gradualist approach, narrowing the operating limits on the provision of reserves and the fluctuations of interest rates. Further abrupt moves toward ease would be mistaken, raising the possibility of overstimulation 1-1/2 years from now, given the lags in the effects of monetary policy on the economy. The monetary growth targets should be reduced somewhat from current ranges, reaffirming the Fed's anti-inflation commitment and taking advantage of the slack built into the economy from the deep recession.

- A major aid in the fight against inflation would be a TIP (Tax-Based Incomes Policy) of tax credits to wage earners for accepting lower wage increases. If the credits were selected to keep disposable income essentially constant, wage-earners would be indifferent as to the source, business costs would decline substantially, and price inflation moderate. Such a policy measure, as simulated in the DRI Model of the U.S. Economy, would provide a "disinflationary snock" to the economy and bring:

    - significantly lower price and wage inflation over the next five years;

    - lower unemployment rates;

    - enhanced business capital formation and greater productivity growth;

    - an increased pace of real economic growth.

- The cost of a modest TIP program, before feedback effects, designed to induce workers to accept a two percentage point reduction in the growth of wages, would range from $20 to $30 billion per annum with additional losses in Federal and state tax revenues because of lower inflation. But the benefits to the economy as a whole, reductions of inflation and unemployment, increased mortgage finance and homebuilding, and enhanced flows of savings and investment would more than outweigh the negative impacts from the higher Federal budget deficit.

- The lessons of the past include the need for 1) a recognition of the tradeoff between monetary and fiscal policies, with closer coordination between them to prevent conflicts; 2) the use of policies, such as a TIP (Tax-Based Income Policy), other than a severe, generalized restriction of monetary policy in the battle against inflation; 3) more patience on the part of the central bank in waiting for the lagged effects of previous changes in monetary policy to appear; and 4) avoiding overkill in the late stages of expansion and similarly not overstimulating in the early stages of recovery.

The Recession: Cure or Crisis?

The U.S. economy is in the throes of a "mild austerity" set to last into 1981 (Table I, DRI Outlook for the U.S. Economy-Interim July 20, 1980) characterized by a recession, initially the deepest in the postwar period; sharply rising unemployment; still severe inflation; slow growth in productivity; and relatively high levels of nominal interest rates for an economy in slack. Current DRI projections show a three quarter downturn, with a peak-to-trough decline in real GNP of 4.2%. From the fourth quarter of 1979 to the fourth quarter of 1980, the drop is 3.9% (Table 2, Economic Outlook for 1980 and 1981). The rate of decline in the economy should be less steep in the second half of this year, with real economic growth down about 5 to 6% during the third quarter and 1-1/2 to 2% in the fourth quarter. The unemployment rate is projected to peak at 9.0% in 1980:1, a sizeable increase from the 5.9% of 1979:4. By the fourth quarter of this year, the unemployment rate should be 8.8%, representing a rise of 1.7 million persons in the ranks of the unemployed compared with 1979:4.

Table I
Data Resources Outlook for the U.S. Economy
Interim July 20, 1980

	1979	1980				1981				Years			
	IV	I	II	III	IV	I	II	III	IV	1979	1980	1981	1982
GNP and Its Components Billions of Dollars - SAAR													
Total Consumption	1580.4	1629.5	1628.2	1660.5	1699.4	1747.5	1795.8	1850.3	1907.0	1509.8	1654.4	1825.2	2049.9
Nonres. Fixed Investment	265.2	272.6	265.9	[illegible]	255.1	266.2	271.0	277.1	285.3	254.9	267.0	274.9	310.9
Res. Fixed Investment	116.4	110.4	89.3	87.0	88.1	96.8	109.3	122.3	134.6	114.1	93.7	115.7	154.3
Inventory Investment	5.6	4.7	11.7	-12.9	-20.7	-9.5	-0.7	8.5	9.8	18.1	-4.3	2.0	18.9
Net Exports	-11.9	-13.6	1.3	-11.1	-10.0	-15.0	-15.1	-13.8	-15.4	-4.6	-8.4	-14.8	-12.3
Federal Purchases	178.4	186.2	192.5	200.7	206.2	211.2	216.2	220.9	226.5	166.7	196.4	219.3	244.6
State and Local Govt. Purchases	322.8	331.0	334.5	340.4	346.1	354.9	362.2	370.8	378.4	309.8	338.0	366.6	400.4
Gross National Product	2456.9	2520.8	2523.4	2529.1	2574.2	2652.0	2738.7	2836.1	2926.5	2368.8	2536.9	2788.8	3166.6
Real GNP (1972 Dollars)	1440.3	1444.7	1410.8	1390.1	1384.6	1399.2	1415.5	1435.9	1451.0	1431.6	1407.6	1425.4	1494.9
Prices and Wages - Annual Rates of Change													
Implicit Price Deflator	8.3	9.5	10.4	7.1	9.0	8.0	8.6	8.6	9.0	8.9	9.0	8.5	8.3
CPI - All Urban Consumers	13.6	16.9	13.5	10.3	8.3	8.2	9.6	9.0	9.0	11.3	13.5	9.0	8.8
Producer Price Index - Finished Goods	15.0	17.1	9.5	11.1	12.5	11.8	11.2	10.7	10.3	11.1	13.2	11.4	9.8
Compensation per Hour	9.4	10.2	9.3	9.0	9.0	11.5	9.5	9.7	9.1	8.9	9.3	9.8	9.7
Core Inflation	8.4	8.6	8.8	9.1	9.2	9.2	9.1	9.0	8.9	8.2	8.9	9.0	8.8
Production and Other Key Measures													
Industrial Production (1967=1.000)	1.522	1.522	1.447	1.381	1.368	1.387	1.427	1.471	1.509	1.521	1.429	1.449	1.581
Annual Rate of Change	-0.3	0.1	-18.2	-17.2	-4.3	6.4	11.8	13.2	10.8	4.1	-6.1	1.4	9.1
Housing Starts (Mil. Units)	1.593	1.263	1.045	1.116	1.188	1.382	1.564	1.684	1.788	1.722	1.153	1.605	1.881
Retail Unit Car Sales (Mil. Units)	9.8	10.7	7.7	8.1	8.5	8.8	9.2	9.5	10.0	10.7	8.8	9.4	10.8
Unemployment Rate (%)	5.9	6.1	7.5	8.1	8.8	9.0	8.8	8.5	8.4	5.8	7.6	8.7	7.8
Federal Budget Surplus (NIA)	-15.7	-22.9	-41.2	-74.5	-76.3	-83.3	-65.8	-58.3	-49.6	-11.4	-53.7	-64.2	-27.8

Table I (Continued)

Money and Interest Rates													
Money Supply (M-1A)........................	368.1	372.5	368.9	373.3	377.0	381.5	386.4	391.7	396.9	368.1	377.0	396.9	419.2
Annual Rate of Change..............	4.6	4.9	-3.8	4.9	4.0	4.8	5.3	5.6	5.4	5.0	2.4	5.3	5.6
New AA Corp. Utility Rate (%).........	11.63	13.83	12.29	11.07	10.47	10.17	10.29	10.44	10.68	10.24	11.84	10.39	11.43
New High-Grade Corp. Bond Rate (%)...	11.01	13.05	11.17	10.49	10.13	9.81	9.92	10.06	10.29	9.86	11.21	10.02	11.01
Federal Funds Rate (%).................	13.58	15.05	12.69	8.56	8.02	7.70	8.29	8.63	9.30	11.19	11.00	8.48	10.20
Prime Rate (%)............................	15.08	16.40	16.32	10.70	9.84	9.51	9.87	10.12	10.56	12.67	13.31	10.01	11.26
Incomes - Billions of Dollars													
Personal Income............................	2005.0	2057.4	2078.3	2116.9	2163.0	2207.8	2263.1	2337.6	2408.2	1924.2	2103.9	2304.2	2594.1
Real Disposable Income (%Ch)..........	1.1	0.9	-5.6	-1.4	-1.5	2.5	0.5	4.4	3.2	2.3	-1.0	0.6	3.4
Saving Rate (%)............................	3.5	3.7	4.7	5.0	4.9	5.0	4.6	4.6	4.2	4.5	4.6	4.6	3.8
Profits Before Tax.........................	243.0	260.4	219.8	190.6	185.9	201.7	218.0	232.3	245.4	238.6	214.2	224.2	263.5
Profits After Tax..........................	146.9	158.0	132.4	114.8	112.0	131.6	141.6	149.9	157.2	144.1	129.3	145.1	165.9
Four-Qtr. Percent Change...........	11.0	11.3	-4.9	-22.6	-23.8	-16.7	6.9	30.5	40.4	18.6	-10.3	12.2	14.3
Composition of Real GNP - Annual Rates of Change													
Gross National Product....................	2.0	1.2	-9.1	-5.7	-1.6	4.3	4.7	5.9	4.3	2.3	-1.7	1.3	4.9
Final Sales.................................	3.6	1.5	-9.6	-2.9	-0.7	2.4	3.4	4.6	4.1	2.7	-0.7	0.9	4.3
Total Consumption........................	4.1	0.5	-9.4	-2.1	-0.6	2.2	2.4	4.1	4.3	2.6	-0.9	0.7	4.0
Nonres. Fixed Investment...............	-0.5	1.9	-18.0	-9.4	-6.4	-6.3	-0.8	1.1	4.1	6.2	-3.7	-5.0	4.8
Equipment.................................	-6.0	2.0	-20.3	-7.2	-3.9	-2.8	2.6	3.9	6.0	4.7	-6.1	-2.5	7.0
Nonres. Construction..................	12.2	1.2	-12.6	-13.8	-11.4	-12.9	-7.6	-4.8	-0.2	9.6	-0.7	-10.1	0.1
Res. Fixed Investment..................	-4.9	-26.3	-60.1	-17.2	-3.7	30.5	47.0	42.2	32.9	-5.7	-24.6	11.6	21.9
Exports.....................................	7.1	26.0	-8.8	3.6	6.0	6.5	8.3	6.9	3.8	10.1	8.9	5.2	6.2
Imports.....................................	8.1	10.4	-24.7	12.0	-6.5	0.0	3.9	5.8	6.2	4.4	-0.1	0.1	5.1
Federal Government.......................	16.1	13.3	9.1	8.6	-3.4	3.5	3.8	3.3	-0.2	0.9	7.5	2.9	3.4
State and Local Governments...........	0.9	-0.7	-3.8	-1.6	-2.2	0.1	-0.3	0.9	-0.1	0.2	-0.6	-0.8	0.6

Table 2
Economic Outlook for 1980 and 1981*
(Change from fourth quarter to fourth quarter, percent
except where otherwise stated)

	Actual 1979	Projected 1980	Projected 1981
Nominal GNP	9.9	4.8	13.8
Real GNP	1.0	-3.9	4.8
Implicit GNP Deflator	8.9	9.0	8.6
Consumer Price Index	12.7	12.2	8.7
FRB Index of Industrial Production	1.0	-10.3	10.5
Productivity Growth	-2.0	-1.7	2.8
M1-A	5.0	2.4	5.3
M1-B	7.6	3.4	9.2
M2	8.3	6.4	8.9
Employment (mils. of persons, fourth quarter level)	97.7	96.0	98.3
Unemployment Rate (%, fourth quarter level)	5.9	8.8	8.4

*DRI Interim Forecast, July 20, 1980.

Considerable improvement in real economic growth is in prospect for 1981, with a 4.8% rise over the year. A near $30 billion tax cut for households and business, strengthened new housing activity, a rebound in consumer spending, the end of the down cycle for inventories, a strong pace of military outlays, and the end of balance sheet reliquefication by households and business should bring about the recovery. The strongest period will occur in the second half of 1981.

The recession should be of near average length compared to other postwar downturns, but will be the second largest contraction in the postwar period (Table 3, Recessions in the Postwar Period). Yet, despite the relatively severe downturn, no relief on inflation to far below double-digits can be expected. Even after two years of sluggish real economic growth of -1.7% and 1.3% in 1980 and 1981, respectively, most inflation rates will still be ranging between 8 and 9%. By late this year, the implicit GNP deflator is projected in a range near 9%, reaching an average of 8-1/2% in mid-1981. There is considerable improvement in prospect for inflation, with the fourth quarter-to-fourth quarter change of the CPIU 12.2% in 1980, then 8.7% for 1981. In the case of the implicit GNP deflator, the corresponding figures are 9 and 8-1/2%. But at these rates or even a little less, the gains on inflation from the recession must be described as disappointing.

Table 3
Recessions in the Postwar Period

		Real Economic Growth (%)				Consumer Price Index (%)		
Peak	Trough	Duration Months	At Peak	At Trough	Duration	Peak	At Trough	Duration
November 1948	October 1949	11	4.2	-3.4	-1.4	-7.0	-4.8	-2.1
July 1953	May 1954	10	-2.4	-1.6	-3.3	-0.1	3.2	0.8
August 1957	April 1958	8	2.8	2.9	-2.5	3.9	2.0	2.4
April 1960	February 1961	10	-1.0	2.6	-0.3	5.9	0.8	1.5
December 1969	November 1970	11	-2.2	-3.9	-0.6	7.7	5.2	5.6
November 1973	March 1975	16	2.1	-9.0	-5.7	11.1	5.5	14.6
January 1980	December 1980F	11F	1.6	-1.8	-4.2	17.0	8.3	7.9

		Unemployment Rate (%)				Housing Starts (Mills. of Units¹ (%)		
Peak	Trough	Duration Months	At Peak	At Trough	Duration	Peak	At Trough	At Duration
November 1948	October 1949	11	3.8	7.9	4.1	1.196	1.462	46.3
July 1953	May 1954	10	2.6	5.9	3.3	1.366	1.423	1.0
August 1957	April 1958	8	4.1	7.4	3.3	1.192	1.156	0.3
April 1960	February 1961	10	5.2	6.9	1.7	1.289	1.226	-3.6
December 1969	November 1970	11	3.5	5.9	2.4	1.227	1.667	30.1
November 1973	March 1975	16	4.8	8.5	3.7	1.726	0.993	-40.6
January 1980	December 1980F	11F	6.1	8.8	2.7	1.419	1.180	-5.9

F = DRI Forecast

Along with the still high inflation will be relatively high interest rates for a recession-recovery period, preventing the usual huge resurgence of deposit inflows to thrift institutions. A prime rate of 9 to 9-1/2%, three-month Treasury bill rate of 7% or so, and bond yields ranging between 9 and 10-1/2% at the trough in early 1981 are the current projections.

Monetary growth is likely to fall below Fed long-run targets, assuming that the Federal Reserve does not aggressively attempt to offset the first half shortfall of M1-A and M1-B. Current DRI projections show only a 2.4% rise of M1-A between 1979:4 and 1980:4 and 3.4% for M1-B, well below the lower 3-1/2 and 4-1/2% limits on the long-run goals. To achieve the Fed year-over-year growth targets, further declines of 300 to 400 basis points in money market rates would be required. It is unlikely that the central bank will promote this additional easing, given continuing dollar weakness and fears of overstimulation in later years.

The current outlook suggests major, continuing problems for the U.S. economy. Despite the relatively deep recession that is predicted, inflation rates will remain at 8 to 10%, on average, for most of the next few years. With the unemployment rate still at 7.8% in 1982, the dimensions of the "mild austerity" in the U.S. economy remain too long. In addition, productivity growth, even with the $30 billion tax cut assumed in the DRI forecast, moves up quite sluggishly and interest rates remain high by historical standards. Thus, the dimensions of the recession hardly suggest a cure for the ills of the U.S. economy.

How did the U.S. economy get to this position? The current episode was assured by a severe oil and energy price crunch on real income; overextended debt positions in the private sector, especially for households; a squeeze on real purchasing power by an unprecedented inflation; a restrictive setting for both fiscal and monetary policy in order to deal with double-digit inflation; and an aged expansion. However, as almost always has been the case, it took the "financial factor" in the business cycle to finally push the economy into the recession, with a full-blown credit crunch intensifying the downturn in the economy to the current proportions.[2]

The crunch appeared definitively in the fourth and first quarters of 1980, subsequent to the New Fed Policy of October 6, after a long period of economic expansion, rising debt, double-digit inflation, and tight money. The characteristic squeeze on the liquidity of bank and thrift institutions, credit rationing to households, inverted yield curves, rapid upward acceleration of interest rates, chaotic bond markets, and near failure of some corporations (Chrysler) and financial institutions (First Pennsylvania) all were symptoms of the crunch.

It is now clear that the recession was in process at the very time the central bank was engaging in the severest application of monetary restraint for this episode, with a heavy dose of overkill through a huge draining of bank reserves during February-March and the imposition of unprecedented peacetime credit controls. Had the Fed simply waited for the previous doses of tight money, including those of October 6, to work through the economy with the usual six-to-nine month lags and recognized the temporary nature of the shelter-oil oriented 18% inflation rates in January through March, the economy would have grown sufficiently weak rather than being propelled into the deepest initial downturn of the postwar period. By tightening so sharply, central bank policy actually was a major source of instability, with the Consumer Price Index reflecting higher mortgage rates and business loan demands accelerating for fear of credit controls. And, as always, most particularly in recent years, the payoff on reducing inflation was highly in doubt.

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[2] See A. Sinai, "Crunch Impacts and the Aftermath," Data Resources Review, June 1980, pp. 37-60.

Will the recession cure inflation? Unfortunately, the recession is unlikely to "cure" the current inflation or eliminate most of the permanent part of it. If the inflation were primarily caused by excess demand, i.e., "too many dollars chasing too few goods", then the credit crunch and recession would have been welcome medicine. However, the problem is that the current inflation is multi-dimensioned, with a variety of causes not fully amenable to a single type of policy. These causes of inflation can be classified as cost-push, shock-related, and demand-pull. The bulk of the current inflation is due to cost-push and shock factors, rather than excess demand. DRI has essentially designated the cost-push inflation as "core" inflation and determined that this element is currently about 8 to 10% of the total.[3]

With so much current inflation of the core variety, tough demand-management policies are doomed to failure, although continued restraint in fiscal and monetary policy must be a prerequisite to effective long-run control of inflation. On the other hand, a policy of extreme restraint, such as was put in place last October, is only likely to succeed in creating a deep recession. Indeed, the accelerating tightness in monetary policy after last October was actually associated with a greater acceleration of inflation, through effects on shelter costs and the cost of capital. At best, the recession is denting some seven to ten pecentage points off the 18% inflation of early this year, leaving 8 to 10% still to be eliminated. And, it may even be that much of the improvement would have occured anyway, as the special factors of energy and shelter inflation eased off.

The Role of Monetary Policy: Retrospect and Prospect

Monetary policy has become increasingly important during the postwar period as a tool of stabilization policy, due to both a greater appreciation for the role of money and finance and as other policies either have been eschewed or implemented only periodically or too slowly. The conventional wisdom about the impacts of the Federal Reserve on the economy has undergone a radical shift from the early days of Keynesian economics. Still unknown, however, are the details of the transmission mechanism for monetary policy and the lags. In the DRI Model of the U.S. Economy, the role of Fed policy occurs primarily through the banking system and sectoral portfolio adjustments that impact on flows-of-funds and spending along with changing interest rates. The DRI Model includes substantial impacts for interest rates and stock prices on spending, although through the somewhat unconventional means of debt service, repayment burdens, and financial risk for households and business. All in all, the Federal Reserve plays a decisive role in the framework of the economy modeled by DRI, so that in our forecasting and policy studies considerable attention is paid to money and finance.

A. Retrospect: A Familiar Pattern

In retrospect, and unfortunately, the performance of the central bank during this experience has not differed much in final results from other episodes in the postwar period.

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[3] See O. Eckstein, "Tax Policy and Core Inflation," Data Resources Study Prepared for the Joint Economic Committee, March 1980.

Two statements made in previous writing and testimony still ring true, with my arguments unchanged.[4]

(September 1975) The recent unexpected burst of inflation highlights the dilemma of contemporary monetary policy. Higher prices, regardless of the origin, result in an increased transactions demand for money. Most estimates suggest a unitary elasticity of the demand for money with respect to the rate of inflation. Given a policy that is directed at achieving fixed rates of growth in money, inflation-induced monetary growth may exceed the targets set by the central bank.

Monetary policy must then be tightened by draining reserves from the banking system; with subsequent increases for interest rates on Federal funds, U.S. Treasury securities, non-deposit liabilities, and eventually the prime rate.

Economic expansion is slowed and the hope is that inflation will ease, but therein lies the fallacy in the current practice of monetary policy. The response of the economy to monetary restriction has been a reduction in the quantities of output and employment rather than falling prices, and as volume has dropped producers have charged higher prices to maintain profits, moving up the demand curve for a given product. The prime example of this phenomenon has been in the last two years where inflation and tight money caused the deepest recession since the 1930s, but failed to eliminate the worst inflation of the postwar period.

The tendency toward quantity adjustments and perverse price behavior in periods of lessened demand constitutes a fundamental structural change in the U.S. economy, complicating the task of monetary policy. The greater the degree of cost-push inflation, or price increases from external shocks, the more futile is the use of monetary policy as a tool of stabilization.

The failure of the last recession to limit inflation to acceptable rates should be sufficient evidence that the price mechanism is not acting in traditional fashion. As long as the Federal Reserve chooses monetary growth targets that require rapid price adjustments for their realization, the inevitable result will be a sluggish economy with high unemployment of resources.

. . . .

(May 1973) The Federal Reserve overplayed its role in every episode by attempting to maintain a restrictive monetary policy for longer than was necessary. Yet, the monetary authority never intentionally sought to produce a Crunch. . . Why did the Federal Reserve overstay its tight stance? The most likely answer is that the monetary authority probably did not appreciate the potency of monetary policy or have adequate knowledge of the lags between policy implementation and its effects. The central bank, in reacting strongly to contemporaneous signals such as inflation, maintained a tight posture for too long. It was difficult to ease up on policy prior to signs of significant economy slowdown and reduced inflation. Yet in order to avoid overkill, monetary policy, because of the lags, must turn before full proof of the sucess of earlier restrictive policy appears. Precisely the same possibility for error exists at this time if slower monetary growth is to be awaited as a signal of policy success. If monetary policy is kept tight until a time of substantially slower monetary growth, overkill will have been applied.

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[4] A. Sinai, "Fed Can't Check Food, Energy, Inflation, by Slowing M1 Growth," The Money Manager, September 15, 1975 and A. Sinai, "The Conduct of Monetary Policy: Performance and Prescriptions," Testimony Presented for the Fifth Meeting on the Conduct of Monetary Policy, Hearings, Committee on Banking, Housing, and Urban Affairs, United States Senate, May 10, 1977. A. Sinai, "Credit Crunches-An Analysis of the Postwar Period," in O. Eckstein, ed., Parameters and Policies in the U.S. Economy (Amsterdam, North-Holland, 1976), pp. 244-274.

That the Federal Reserve once again overstayed a tight monetary policy stance is indicated by Table 4, which shows unprecedented rises in nominal interest rates between the start of the New Fed Policy and mid-March, especially in February and March. Table 5 indicates the sweeping restriction of Fed policy that was applied in the first quarter of the year, with reductions in nonborrowed reserves of 13.5% in February and 21.8% in March along with other indications of an exceptionally tight monetary policy. However, we now know that the economy was already in recession during February and March so that the squeeze in policy at that time was being superimposed, as in other instances, on an already weak economy. Given six-to-nine month lags before the bulk of the effects occur from any change in monetary policy, it is easy to see that much of the second quarter weakness in the economy can be attributed to tight money.

Indeed, subsequent behavior by the Federal Reserve suggests a recognition that the unprecedented restriction may have been misguided. Once the economy began its freefall, the New Fed Policy permitted sharp declines in short-term interest rates to a greater degree than in previous episodes. This was done without any "easing" in the new policy framework. However, in late April through June, the Fed actively promoted additional easing by aggressively supplying reserves to the banking system.

Table 4
Interest Rate Increases Since The New Fed Policy

						Cumulative Rate Increases (Basis Points)		
	July 18, 1980 (*1) (%)	March 17, 1980 (*2) (%)	Feb. 1, 1980 (%)	Oct. 5, 1979 (%)	Aug. 3, 1979 (%)	March 17-July 18	Feb. 1-March 17	Oct.5-Feb. 1
Short-Term:								
Federal Funds	8.50	19.96	13.46	11.91	10.69	-11.46	6.50	1.55
3-Month Treasury Bills	7.94	16.00	12.17	10.26	9.38	-8.06	3.83	1.91
4-6-Month Commercial Paper (*3)	8.63E	17.37	13.01	11.76	9.99	-8.74	4.36	1.25
90-Day CD's	8.60	18.59	13.34	12.01	10.23	-9.99	5.25	1.33
3-Month Eurodollars	9.19	19.60	14.41	12.79	11.13	-10.41	5.19	1.62
Prime Bank Loans	11.25	20.00	15.25	13.50	11.75	-8.75	4.75	1.75
Discount Rate	11.00	13.00	12.00	11.00	10.00	-2.00	1.00	1.00
Intermediate-Term:								
3-5-Year Treasury Bond (Constant Maturity)	9.30E	14.02	11.34	9.73	8.96	-4.72	2.68	1.61
Long-Term:								
AAA-Equivalent Corporate Bonds	10.81	14.07	11.66	10.25	9.23	-3.26	2.41	1.41
AA-Utility	11.60	15.06	12.29	9.67	9.72	-3.46	2.75	2.62
Bond Buyer Index of 20 Municipal Bonds	8.03	9.44	7.52	6.64	6.14	-1.41	1.92	0.88
U.S. Government Bonds (Constant Maturity)								
10-Year	10.22E	13.17	11.29	9.53	8.92	-2.95	1.88	1.76
20-Year	10.32E	12.89	11.30	9.38	8.93	-2.57	1.59	1.92

(*1) 4-Month Commercial Paper and U.S. Government Bonds estimated (E).

(*2) Federal Funds as of April 3; 3-Month Treasury Bills as of March 25; 4-Month Commercial Paper as of April 5; 3-Month Eurodollars as of April 4; Prime Bank Loans as of April 2; 3-5-Year Treasury Bond as of March 24; AAA-Equivalent Corporate Bonds and AA-Utility as of April 3; Bond Buyer of Index as of March 20; 10-Year Government Bonds as of March 24; and 20-Year Government Bonds as of March 25.

(*3) As of October 31, 1979 4-6 month series discontinued, 4-month series begun.

The contrast in the growth of bank reserves between February-March and April-June is striking. In the former period, bank reserves were drained at 15 to 30 percent rates. In the latter period, nonborrowed reserves grew at 30 to 50% rates. And, as Table 4 shows, the resulting declines of interest rates over the three month period more than wiped out the rises from October 5, 1979 to mid-March. In effect, what happened during the second quarter was a complete erasing of the sweeping restriction of the earlier months, which suggests recognition of the error in reacting so strongly to the temporary 18% rates of inflation earlier this year.

Table 5
Monetary Policy Indicators

	Latest*	1980						1979	1980		1979	
		June	May	Apr.	Mar.	Feb.	Jan.	Dec.	II	I	IV	III
Federal Funds Rate (%)	8.90	9.47	10.98	17.61	17.19	14.13	13.82	13.78	12.69	15.05	13.58	10.95
Free Reserves (Bils. of dollars)..	-.02	-.17	-0.84	-2.19	-2.62	-1.44	-0.99	-1.03	NC	-1.69	-1.48	-0.99
Monetary Base %CH................	8.8	9.9	4.7	3.1	7.1	9.7	7.2	10.7	5.8	8.1	8.9	10.4
Total Reserves %CH................	-16.9	-8.4	-11.3	39.6	9.4	-2.5	-3.4	15.2	NC	5.2	19.1	4.8
Nonborrowed Reserves %CH................	0.5	8.7	31.9	58.5	-21.8	-13.5	3.0	31.3	NC	4.4	12.9	5.7
Bank Credit %CH................		NA	-5.5	-4.2	2.6	20.5	13.8	4.2	NA	12.1	3.5	16.8
M-1A Growth %CH................	11.3	12.0	0.7	-18.3	-1.9	9.8	3.6	5.7	-1.9	3.7	4.2	7.4
M-1B Growth %CH................	14.6	16.0	-1.5	-13.2	-0.3	10.4	5.4	7.1	-0.3	5.1	4.5	9.2
M2 Growth %CH................		18.8	8.9	-2.0	4.8	10.0	7.3	7.4	8.2	7.3	6.2	10.5
Real M-1A Growth %CH................		NA	-9.2	-25.0	-17.3	-6.7	-12.2	-8.7	NA	-12.2	-8.4	-5.6
Real M-1B Growth %CH................		NA	-11.2	-22.2	-16.0	-6.3	-10.7	-7.5	NA	-11.0	-8.1	-4.1
Real M2 Growth %CH................		NA	-1.8	-12.1	-11.7	-6.6	-9.0	-7.2	NA	-9.1	-6.7	-2.9

*As of July 16, 1980. Nominal MM1-A and MM1-B as of July 9, 1980.

While the Federal Reserve is to be lauded for quickly moving to a less restrictive state, one can only look at the policy of the last six months with amazement. "Stop-go" monetary policy was applied to an unprecedented degree, in terms of interest rates, reserves, and monetary growth. Surely, the practice and performance of monetary policy during this period leaves much to be desired.

B. The New Fed Policy: Help or Hindrance?

It is now nine months since the Federal Reserve instituted a new approach to monetary policy. The major innovation involved shifting from interest rate targeting to controlling bank reserves. The shift in policy represented a radical turn for the central bank, with wide fluctuations of short-term interest rates permitted given constraints on bank reserve growth instead of fixing interest rates and permitting bank reserves to be highly variable. The underlying premise for the policy was the notion that the relation between monetary growth and bank reserves would be more regular and reliable than the one between monetary growth and short-term interest rates.

So far, it appears that the New Fed Policy helped in only one way, i.e., the speculative excesses in gold and other precious commodities were interrupted. Sharply rising commodity prices prior to the New Fed Policy had threatened a panic flight from paper money into hard commodities.

Initially, the New Fed Policy did help the dollar. But subsequent moves to higher interest rates in the rest of the world to deal with inflation at the same time U.S. interest rates were falling have brought a net drop in the relation of the dollar to other currencies. Since October 5, the dollar has dropped against the yen by 2.5%, is down by 2.5% against the French franc, is lower by 1.3% vs. the German mark, and off 8.1% against the British pound. A small gain of 1.2% has occurred vis-a-vis the Swiss franc.

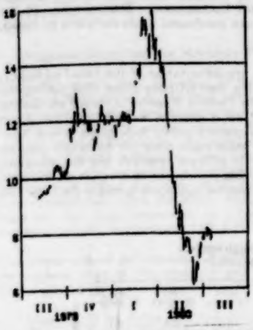
Table 6
Dollar vs. Major Foreign Currencies
(Bid, % change as of today)

	Yesterday 7/16/80	1 Week Ago 7/10/80	Interest Rate Peak 3/26/80	Day Before New Fed Policy Revealed 10/5/79	Volcker Becomes Chairman of Federal Reserve 8/6/79	Day Before Fed-Treasury Accord 10/31/78	One Year Ago 7/15/79
Yen	0.0	0.6	-12.1	-2.5	1.0	23.3	1.8
Fr. Franc	-0.4	-0.2	-8.1	-2.5	-5.2	0.9	-4.0
Sw. Franc	-0.4	0.0	-10.8	1.2	-3.6	8.1	-1.8
German Mark	-0.3	-0.2	-8.2	-1.3	-5.2	0.4	-3.7
Pound	-0.2	-0.2	-7.4	-8.1	-5.2	-12.1	-3.5

Source: DRI-FACS (Financial and Credit Statistics Information Service)

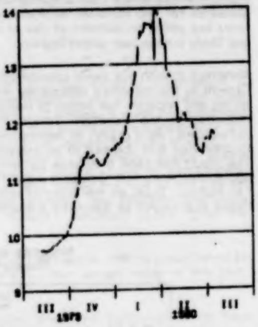
With respect to the domestic economy, the New Fed Policy brought about a full-blown credit crunch with 1) sharply accelerated rises of short- and long-term interest rates, 2) widening yield spreads between the highest and lower quality debt, 3) intensified disintermediation, 4) a severe squeeze on bank liquidity, 5) record-high borrowing rates, and 6) deepened financial instability for households and business. The result was the recession. Since a goal of the New Fed Policy certainly was not the kind of deep recession that has occurred, the New Fed Policy must be deemed a failure in this respect.

Chart 1
Three-Month Treasury Bill Rate
(Percent, daily quoted yield)



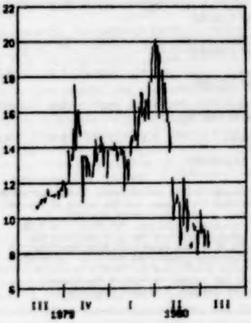
(Aug. 6, 1979-Oct. 5, 1979) Mean = 9.93%; Standard Deviation = 0.40%.
(Oct. 6, 1979-Dec. 31, 1979) Mean = 11.93%; Standard Deviation = 0.35%.
(Jan. 1, 1980-Mar. 14, 1980) Mean = 13.60%; Standard Deviation = 1.32%.
(Mar. 15, 1980-July 18, 1980) Mean = 10.01%; Standard Deviation = 3.08%.

Chart 2
Average Corporate Bond Yield
(Percent)



(Aug. 6, 1979-Oct. 5, 1979) Mean = 9.87%; Standard Deviation = 0.15%.
(Oct. 6, 1979-Dec. 31, 1979) Mean = 11.21%; Standard Deviation = 0.30%.
(Jan. 1, 1980-Mar. 14, 1980) Mean = 12.57%; Standard Deviation = 0.82%.
(Mar. 15, 1980-July 18, 1980) Mean = 12.41%; Standard Deviation = 0.83%.

Chart 3
Federal Funds Rate, Overnite
(Percent, daily quote yield)



(Aug. 6, 1979-Oct. 5, 1979) Mean = 11.29%; Standard Deviation = 0.37%.
(Oct. 6, 1979-Dec. 31, 1979) Mean = 13.73%; Standard Deviation = 1.10%.
(Jan. 1, 1980-Mar. 14, 1980) Mean = 16.44%; Standard Deviation = 1.26%.
(Mar. 15, 1980-July 18, 1980) Mean = 12.71%; Standard Deviation = 4.60%.

What have been the impacts of the new monetary policy so far on the financial markets? Table 6 shows the interest rate rises and declines since the New Fed Policy. Charts 1 to 3 show the volatility of some key interest rates before and after the change in policy. Clearly, interest rates have swung wildly since the New Fed Policy, having risen to unprecedented levels then dropping considerably more than at any other time in history. Measures for the variation of the rates show great fluctuations. The volatility of the rates has added an element of risk to investment and purchased funds decisions by banks, and likely pushed loan prices higher.

Monetary growth has eased considerably since the implementation of the New Fed Policy. Growth in the monetary aggregates weakened to the slowest pace since 1959 during the spring and recently has begun to reaccelerate. The Federal Reserve achieved its desired reduction in the monetary growth rates, indeed to a greater extent than had been anticipated. As a result, an aggressive easing of monetary policy took place in late April to June that now appears to be associated with a more rapid pace for monetary growth. The result has been a volatile pattern in the growth of bank reserves and the monetary aggregates since last October, suggesting considerable instability as a result of the New Fed Policy. Thus, on the score of monetary and reserve aggregate growth, the New Fed Policy also cannot be deemed a success.

Table 7
Monetary and Reserve Aggregates: Recent Growth Rates (%)*

	Last Month	Last 8 weeks	Last 13 weeks	Last 26 weeks	Last 52 weeks
M1-A (1) (SAAR, as of 7/09/80)	11.3	9.8	-0.6	0.9	3.1
M1-B (2) (SAAR, as of 7/09/80)	14.6	11.6	1.3	2.0	4.4
Total Reserves (3) (SAAR, as of 7/16/80)	-18.9	-20.2	-6.4	0.5	7.6
Total Reserves (4) (SAAR, as of 7/16/80)	5.2	0.4	1.6	0.4	6.1
Nonborrowed Reserves (3) (SAAR, as of 7/16/80)	-8.5	7.0	13.1	4.3	10.4
Nonborrowed Reserves (4) (SAAR, as of 7/16/80)	14.1	18.4	22.1	4.4	8.9
Monetary Base (SAAR, as of 7/16/80)	8.8	9.2	7.3	6.7	8.0
Less Currency (SAAR, as of 7/09/80)	2.7	3.0	0.6	2.5	5.9
Adjusted Federal Reserve Credit (SAAR, as of 7/16/80)	7.3	11.3	9.9	5.9	8.0

* Percent change, simple annual rates; 4 week average ending on date indicated from 4 week average ending at the earlier period.

(1) M1-A equals currency plus demand deposits.
May-June targeted growth rate for M1-A, 7 to 7.5%.
1980 targeted growth rate for M1-A, 3-1/2 to 6%.

(2) M1-B equals M1-A plus other checkable deposits.
May-June targeted growth rate for M1-B, 7.5 to 8%.
1980 targeted growth rate for M1-B, 4 to 6-1/2%.

(3) Unadjusted for changes in reserve requirements.

(4) Adjusted for changes in reserve requirements.

Will the New Fed Policy bring significant reductions in the rate of inflation? The answer will not be known for quite some time, but given the multi-dimensioned nature of U.S. inflation, it is hard to expect any major near-term success. More likely, there will be a considerably weaker economy than otherwise, and a deeper recession with no concomitant improvement on inflation unless much later. To achieve a permanent sizeable reduction in the rate of inflation, a restrictive course would be necessary for at least two or three years.

C. Prospects: What Next for Monetary Policy?

Given the current deep recession in the economy and still high rates of inflation, it is clear that Fed policy has not been consistent with previously stated Administration goals of a gradual slowdown and considerably lower inflation. Of course, it must be recognized that Fed policy alone cannot possibly produce results that would be consistent with the goals of any Administration. External shocks, ranging from unexpected rises in OPEC oil prices to drought effects on food prices, almost certainly will always create severe problems for the successful implementation of monetary policy. Lack of coordination between Fed policy and other stabilization measures also makes the role of the central bank considerably more difficult. And, international economic and financial considerations are now more important as a constraint on domestic monetary policy, given the potential impacts on domestic U.S. inflation.

The proper stance for monetary policy for the rest of 1980 and in 1981 is conditioned by the current state of the economy and the need to avoid the errors made in the past. Therefore, I urge:

- Less volatility in the practice of monetary policy. Since the institution of the New Fed Policy, monetary policy has been more "stop-go" than previously had been the case whether measured in terms of growth in reserves, monetary growth, or fluctuations of interest rates. The danger is that monetary policy is becoming more of a contributor to instability than to stability. In terms of the new approach to policy, greater stability could be achieved through more narrow ranges for allowable growth in nonborrowed reserves and narrowing the bounds on the Federal funds rate. Although a step backwards from the new operating approach set last October, some modification seems appropriate given the considerable instability of the financial markets and the economy since last October. With the New Fed Policy far from a success, it is time to make modifications.

- More patience on the part of the central bank in recognition of the lags before changes in monetary policy impact the economy, monetary growth, and inflation. Had the central bank waited rather than moving toward severe restriction in February and March, the downturn in the middle two quarters of this year would have been mitigated considerably. Lags of six to nine months are common before a tighter monetary policy begins to impact so that during such a time span Fed policy should not continuously be tightened but moved in steps with pauses until the lagged effects impact. Similarly, when stimulating the economy, continued moves toward ease are ill-advised since some six to eighteen months are required before the impacts occur. The lags under an easier monetary policy can be longer than in a regime of tightness, given the reliquefication behavior of households and business. For the rest of 1980 and 1981, the implication is that lower monetary growth than targeted should be tolerated longer to avoid too much stimulus later.

- A lowering of the long-run monetary growth targets, but with the previous wide bands retained to permit flexibility in case of external shocks. With full employment potential growth now about 2-1/2%, a target for inflation of 5% in 1981 would require approximate growth in narrow money of 3-1/2%. Thus, the current 3-1/2 to 6% target range for M1-A and 4 to 6-1/2% range set for M1-B probably should be centered somewhat lower, perhaps at 2-1/2 to 5-1/2%. Lowering the long-run target ranges for monetary growth would take advantage of the reduced demand for money brought on by the recession and set the monetary policy course for the rest of 1980 and 1981 on a path that signifies further reductions of inflation.

- The avoidance of too aggressive an easing to provide an appropriate demand-management background for other stabilization policies. Throughout the decade of the 70s, the Federal Reserve made the mistake of excessive easing almost as much as overkill. Even if in the near-term monetary growth is below Fed short-run targets, too aggressive an easing should not be pursued because of the long lags in the effects of monetary policy.

A major difficultly in the practice of monetary policy over the decades has been an inadequate state of knowledge on the transmission mechanism for monetary policy and the lags. If the Federal Reserve had fully appreciated the manner by which monetary policy was transmitted to the real economy and inflation, then some of the errors of the past might have been avoided. Further, a greater appreciation of the lags, which vary between expansions and declines, is necessary in order to avoid the overkill or overstimulation that has characterized every single business cycle episode since the early 50s. More study on the transmission mechanism of monetary policy, the direct impacts of monetary policy on inflation, and lags in the effects of monetary policy should be undertaken to help prevent a repetition of the volatile swings that have been occurring.

Policy Choices for the 80s: If Not the Recession – How Else to Deal With the Inflation?

There are essentially four policy choices to deal with inflation. First, a recession can eliminate the excess-demand price inflation that is occurring. If the recession is severe enough, inroads on wage inflation also are possible with subsequent benefits on prices. In all the postwar business cycles except for 1966, a recession became the eventual means of dealing with the inflation that was in process. Also, in each recession episode, the "financial factor" or "crunch" performed the key role in pushing the economy downward. The problem with the recession as a weapon against inflation, however, is that the extent of the downturn can never be determined in advance, with dangers of a much deeper slump than originally expected or desired. And, with much more of the current inflation now the "core" variety, the benefits from a recession in reducing inflation are much less than previously.

A second choice involves guidelines on wages and prices or a freeze. Guidelines were employed in the mid-60s, a freeze was used in the late summer and fall of 1971, then guidelines once again last year. Wage and price controls, while a "quick fix" for inflation and certain to break inflationary expectations over the near-term, is risky because of interference with the market price mechanism. The U.S. experience with price-wage freezes and guidelines has not been encouraging. The difficulty in designing an appropriate phase-out is also a problem.

The third policy choice is to sustain sluggish real economic growth for a long period through a backdrop of restrictive monetary and fiscal policies, perhaps applying incomes guideline policies as well. If accompanied by new tax measures to promote capital formation and productivity growth, this approach would certainly bring some lasting improvement. However, the lags before any benefits are likely to be considerable and the changes not of great magnitude. An unemployment rate of 8 to 9% for several years is a necessary characteristic of this choice.

Is there any other way? One approach, not discussed much recently, is TIP. Tax-Based Incomes Policies (TIP) can work through the market mechanism, using either a "carrot" or "stick" approach, or both, to induce behavior in the private sector more consistent with lessened rates of inflation. The principle of a TIP is to apply a "disinflationary shock" in order to generate the reverse effects from those of the previous "inflationary shocks" that have bombarded the U.S. economy since the early 70's. Any measures designed to bring an autonomous reduction of inflation should set into motion enhanced real economic growth, improved real incomes, lower business costs, lessened price inflation, reduced interest rates, improved flows of funds to housing, increased housing activity, increased capital formation, better productivity growth, and reductions in the unemployment rate. These characteristics would be just the opposite of the pattern that has characterized the U.S. economy during the last decade.

I now favor a TIP as an essential ingredient of any policy package designed to deal with the current inflation. The reason is straightforward. If most of the current inflation is due to an excess of wage increases over productivity growth, why not directly attack the rising wages component of the inflation to get maximum benefit with the least deleterious side effects? In the TIP program analyzed in this statement, almost all of the side effects are beneficial.

A simple variant of TIP would be the provision of tax credits to wage-earners who accept a specified lesser rate of wage increases, perhaps two percentage points per annum. The tax credits would be designed to replace the nominal income lost through the lower wage agreements, probably amounting to some $20 to $30 billion per annum. A simple tax credit form, certified by employers, with distributions of the credit throughout the year, would leave wage-earners in essentially an unchanged position with respect to nominal income. But the reduction in wages would considerably reduce labor costs to business, perhaps the most significant element in total business costs. The lessened labor costs would, of course, increase business profits, but also lead to reductions in the rate of price increases. Should businesses fail to pass on a reasonable amount of the reduced labor costs in the form of lower product prices, a "stick" form of TIP could then be applied. But, given the markup pricing policies of most corporations and a slack economy, the pass-through of reduced costs to a lower rate of price inflation would be highly likely.

Once inflation rates began to decline through this mechanism, other benefits would occur. The lower rates of inflation would bring declines for interest rates. The enhanced profits of corporations would stimulate business capital formation and return some of the initial losses in tax revenue to the Federal government. The resulting higher capital formation would aid in raising productivity growth, with additional positive feedback effects on the rate of inflation. Indeed, the lessened inflation would most likely end up raising the real income of wage-earners even though the original tax credits could only maintain an unchanged nominal income position. Knowledge of the likely effects from such a policy would help acceptance, both by the public and Congress, and help break inflationary expectations. The administrative simplicity of a tax credit program, already in place for new expenditures on equipment, a simple form for the taxpayer, and certification by the employer, is an advantage of this TIP proposal. The law passing the TIP would require that the wage and salary earnings covered be the same as currently under the jurisdiction of the Council on Wage and Price Stability. Indeed, administration of the TIP would most appropriately be through this agency.

TIP Effects - A Simulation

A "carrot" variant of TIP, designated as tax credits to all wage-earners in return for acceptance of two percentage points less on wage increases, has been simulated in the 1980 version of the DRI Model of the U.S. Economy. The amount of the tax credit was selected to return wage and salary income to the level that would have existed without the TIP. As a simple example, if the rate of increase for wages was scheduled to be 10% in Year 1, the Federal government would provide a 2% tax credit on the wage base for accepting an 8% rise in wages to hold disposable income at the original level. In subsequent years, the amount of the tax credit would be computed on the basis of the expected baseline wage increase less two percentage points, after-TIP, and applied to the preceding year's wage level. In the simulation, the policy was assumed to be implemented over the next five years. By the end of this period, a permanent break in expected inflation would be in place and the policy could be terminated. The baseline path for spending and monetary policy, the latter in terms of nonborrowed reserves, was assumed from a DRI forecast solution of April 1980.

Calculated in this way, the ex-ante tax loss for the TIP was $26.3 billion in 1980 and $43.1 billion by 1985. However, the net loss in revenues was considerably less, given the increased corporate profits tax receipts that resulted from the reductions in business costs, and ranged from $18 to $30 billion. The mechanics of the program assumed a claim for the tax credit by wage-earners on a quarterly form, certified by the employer, with distributions throughout the year of the tax credit in adjustments to tax withholding schedules. At the end of each year, projections of estimated wages for the next year, without TIP, would be made and then the two percentage point adjustment calculated and tax credits allowed on that basis.

The preliminary results from simulation of such a program are indicated in Charts 4 to 19 and in Table 8.

TIP EFFECTS ON THE U.S. ECONOMY (Wage-earners Accept Two Percentage Points Less Growth in Wages in Return for Tax Credits that Hold Disposable Income Constant)

Raises real growth, . . .

Lowers inflation. . . .

Chart 4
Real Economic Growth:
TIP and DRI Baseline
(Compound annual percent change)

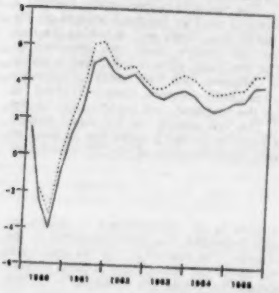
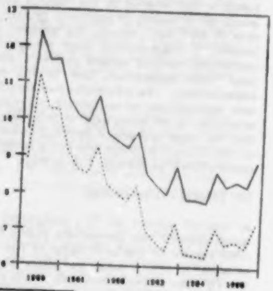
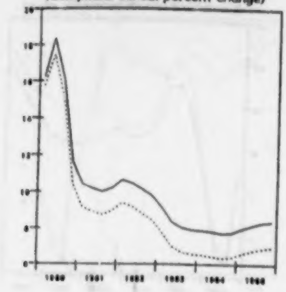


Chart 5
Implicit Price Deflator for GNP:
TIP and DRI Baseline
(Compound annual percent change)



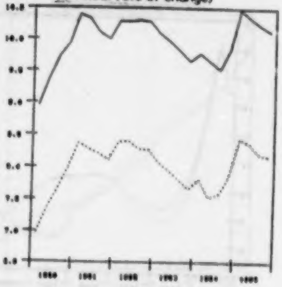
of consumer prices. . . .

Chart 6
Consumer Price Index — Urban:
TIP and DRI Baseline
(Compound annual percent change)



and wages. . . .

Chart 7
Average Hourly Earnings:
TIP and DRI Baseline
(Annual rate of change)



reducing business costs.

Chart 8
Wage and Salary Disbursement:
TIP and DRI Baseline
(Billions of dollars)

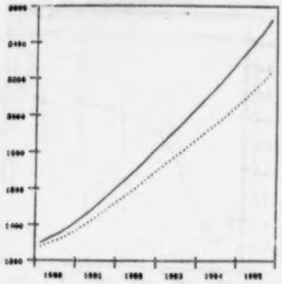
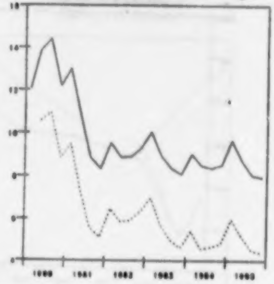


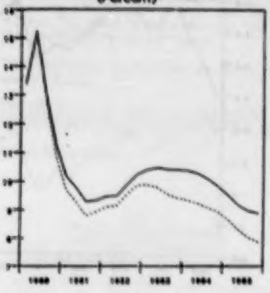
Chart 9
Unit Labor Costs:
TIP and DRI Baseline
(Compound annual percent change)



BASELINE———————————
TIP- - - - - - - - - - - - - - - - - -

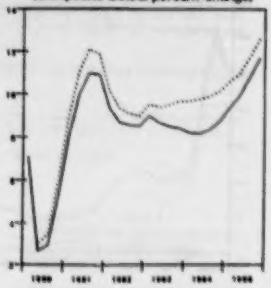
Money market rates are down. . . .

Chart 10
Yield on 3-Month Treasury Bills:
TIP and DRI Baseline
(Percent)



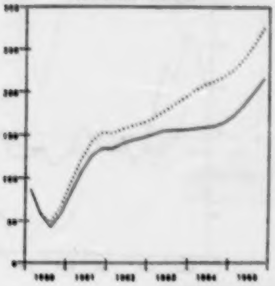
and deposits up. . . .

Chart 11
Deposits at Savings and Loan Assocs:
TIP and DRI Baseline
(Compound annual percent change)



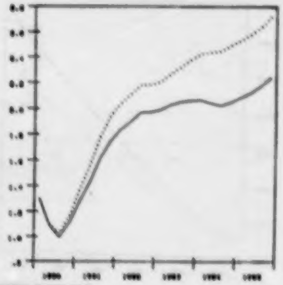
bringing greater mortgage activity. . . .

Chart 12
Mortgage Commitments Outstanding:
TIP and DRI Baseline
(Billions of dollars)



and increased housing activity.

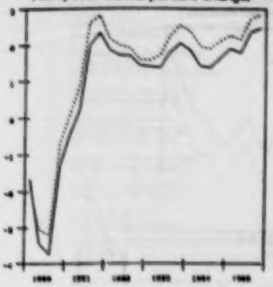
Chart 13
Housing Starts — Total:
(Millions of units)



BASELINE———————
TIP- - - - - - - - - - - - - - - - -

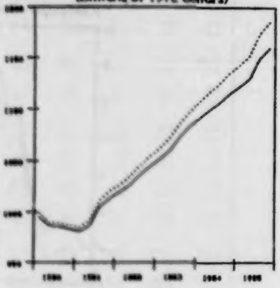
Productivity growth benefits. . . .

Chart 14
Labor Productivity — Nonfinancial Business:
TIP and DRI Baseline
(Compound annual percent change)



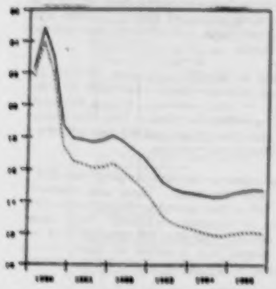
and real income ends up higher.

Chart 15
Real Disposable Income:
TIP and DRI Baseline
(Billions of 1972 dollars)



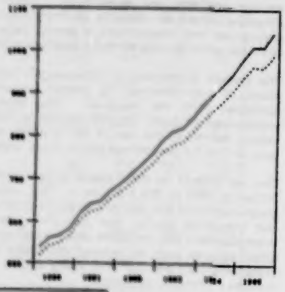
"Discomfort" is down. . . .

Chart 16
"Discomfort" Index:
TIP and DRI Baseline
(Compound annual percent change)



at a relatively low cost in Federal tax receipts.

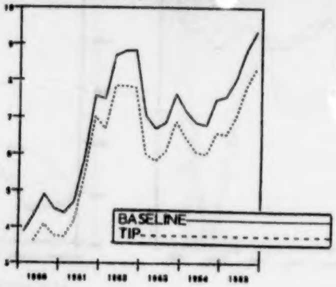
Chart 17
Receipts, Federal Government:
TIP and DRI Baseline
(Billions of dollars)



BASELINE——————————
TIP- - - - - - - - - - - - - - - - -

Money growth is down with the lessened inflation, helping to break inflation expectations.

Chart 18
Money Supply:
TIP and DRI Baseline
(Compound annual percent change)



The results show enhanced real economic growth in the U.S. economy arising from the beneficial effects of the "disinflationary shock" of the TIP program. Reductions of inflation are from 1 to 2 percentage points over the next six years with lower interest rates, greater real disposable income, increased real wealth, and a much improved business cash flow. The results of the higher real incomes in the private sector are increased spending, a greater pace for business capital formation, and a greater flow of savings available for investment. Lower short-term interest rates relative to the effective return on deposits at thrift institutions bring enhanced deposit inflows into savings and loan associations, a greater pace for new mortgage commitments, and reduced costs for some sources of thrift institution lendable funds.

The benefit to housing activity ranges from 100,000 to 500,000 units over the next six years, with an eventual 7% greater amount of real business fixed investment by 1985 compared with the baseline. The improvement in the economy brings increased employment of from 100,000 persons in 1980 to two million in 1985. The "discomfort index", defined as the sum of the inflation rate for consumer prices and the unemployment rate, is 1 to 2.6 percentage points lower under TIP than in the baseline.

The net effects on the Federal budget deficit are incremental rises ranging from $17.1 billion in 1980 to $14.3 billion in 1985, calculated after feedback. These only modestly greater deficits are due to the positive effects of TIP on the economy, corporate profits, and corporate profits tax receipts. Reductions in transfer payments from lower unemployment also mitigate any worsening of the deficit. Use of a TIP does not rule out other policies such as reduced monetary growth staged over a series of years, but is complementary and achieves many of the objectives of any policy aimed at the current malaise of the U.S. economy.

Table 8
Macroeconomic Impacts of a TIP
(Baseline - April 1980 Forecast)

	1980	1981	1982	1983	1984	1985
Economy:						
Real GNP Growth (% chg.)	-1.0	4.4	4.7	4.1	3.8	4.1
(Difference from Baseline)	0.3	1.0	0.5	0.6	0.9	0.6
Real Business Fixed Investment (Bils. of 72 $'s)	152.0	151.5	155.4	165.7	176.8	181.3
(Percent Difference from Baseline)	0.6	2.6	3.9	4.5	6.0	7.2
Housing Starts (Mils. of Units)	1.1	1.7	2.1	2.3	2.5	2.4
(Difference from Baseline)	0.0	0.1	0.2	0.3	0.4	0.5
Inflation and Employment:						
GNP Price Deflator (% chg.)	10.2	8.9	8.1	6.9	6.5	6.8
(Difference from Baseline)	-1.2	-1.4	-1.4	-1.5	-1.5	-1.7
Consumer Price Index (% chg.)	14.7	8.9	9.0	7.0	6.4	6.8
(Difference from Baseline)	-0.9	-1.2	-1.3	-1.4	-1.4	-1.4
Wholesale Price Index (% chg.)	16.8	12.6	11.0	7.3	6.7	7.6
(Difference from Baseline)	-1.1	-1.3	-1.4	-1.5	-1.4	-1.5
Unemployment Rate	6.6	7.3	6.7	6.1	5.6	5.2
(Difference from Baseline)	0.0	-0.3	-0.6	-0.7	-1.0	-1.2
Employment, Nonfarm (Millions of Persons)	90.7	92.2	95.6	98.4	101.0	103.6
(Difference from Baseline)	0.1	0.5	0.9	1.2	1.6	2.0
Discomfort Index**	22.2	17.5	16.9	14.4	13.4	13.5
(Difference from Baseline)	-0.9	-1.5	-1.9	-2.1	-2.4	-2.6
Wages and Productivity:						
Average Hourly Earnings (% chg.)	7.5	8.2	8.3	7.9	7.7	8.3
(Difference from Baseline)	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0
Productivity Nonfarm Business (% chg.)	-2.2	1.6	1.9	2.0	2.1	2.5
(Difference from Baseline)	-.3	0.6	0.2	0.4	0.5	0.4
Income:						
Real Disposable Income (Bils. of 72 $'s)	991.3	1,002.0	1,040.4	1,080.3	1,121.1	1,164.1
(Percent Difference from Baseline)	0.4	0.5	0.8	1.2	1.6	2.1
After-Tax Corporate Profits (Bils. of 72 $'s)	156.9	161.5	197.7	218.9	240.5	270.9
(Percent Difference from Baseline)	6.2	10.1	10.7	10.9	14.4	14.3
Interest Rates:						
3-Month Treasury Bill Rate (%)	13.0	9.2	9.4	9.7	9.1	8.2
(Difference from Baseline)	-0.2	-0.5	-0.4	-0.8	-1.0	-0.9
New Corporate Bond Issues (%)	12.0	11.6	11.8	11.9	11.5	11.0
(Difference from Baseline)	-0.1	-0.2	-0.2	-0.2	-0.3	-0.3
Mortgage Finance:						
Deposits, Savings and Loan Associations (Bils. of $'s)	480.6	520.8	574.9	628.7	689.8	763.7
(Percent Difference from Baseline)	0.2	1.0	1.8	2.4	3.6	4.8
New Mortgage Commitments, Savings and Loan Associations	59.1	117.2	146.7	169.3	195.9	229.9
(Difference from Baseline)	6.3	13.2	12.1	16.6	30.3	29.3
Federal Budget						
Deficit (Bils. of $'s)	-40.0	-19.2	-16.2	-15.4	-8.4	-1.9
Deficit (Baseline)	-22.9	-6.6	-5.4	-0.7	6.7	12.6
Corporate Tax Receipts (Bils. of $'s)	85.7	89.4	95.2	105.1	115.3	130.5
(Percent Difference from Baseline)	6.2	10.2	11.9	12.3	16.3	16.2
Personal Tax Receipts (Bils. of $'s)	235.1	267.0	301.7	338.9	382.6	422.9
(Percent Difference from Baseline)	-7.6	-6.2	-5.5	-6.2	-6.3	-6.4

**Under this TIP, employees accept wage and salary increases that are two percentage points lower than baseline increases, thereby lowering growth in average hourly earnings an estimated two percentage points. The incentive for compliance is provided by the prospects of higher real disposable income and by the government rebating through tax credits 2% of the wage and salary disbursements to bring nominal disposable income to before-TIP estimated levels. The baseline simulations is the April 1980 DRI Forecast of the U.S. Economy.

**The "Discomfort" Index is the sum of the unemployment rate and the percentage change of the Consumer Price Index.

With the only other alternatives in the fight against inflation a deep recession, wage-price freeze or long period of slow growth, the time has come to far more seriously consider a TIP as the preferred treatment for inflation.[5] By offering tax credits to workers in return for lower wages, the resulting "disinflationary shock" would help reverse the damage from the many past "inflation shocks" that have bombarded the U.S. economy. Indeed, the "bang-for-a-buck" of a carrot form of TIP could easily exceed the benefits from investment tax incentives of equivalent cost because of the "multiplier" effects of lessened inflation. And, so long as demand-management policies are held in a restrained posture at the same time, the TIP could be removed later after a permanent break in inflation expectations has taken place.

Lessons for the Future

The mistakes of the past are only valuable in so far as they provide lessons for the future. Some clear pitfalls to avoid emerge from the experience of monetary policy over past years.

First, central bank policy can directly conflict with Federal fiscal policy, either in timing or thrust, working at cross purposes and with deleterious effects on the economy and inflation. Both fiscal and monetary policy need to be more fully coordinated, rather than working at odds, as at some times in the past when aggressive spending and tax policies stimulated the economy to the point where tight money had to be applied. In other instances, both fiscal and monetary policy have been used at the same time to stimulate or restrain the economy, overdoing the extent of the thrust. Policy packages should be developed where the timing and impact can be ascertained and used to determine the size and composition of the policy stimulus.

Second, and perhaps most important, it must be realized that monetary policy alone cannot deal with contemporary inflation. A combination of anti-inflation policies should be utilized, of which monetary policy is only one element. The causes of inflation should be identified, and policies selected that impact directly on the source. Now, with so much of the current inflation due to wage rises in excess of productivity, a heavier dose of policies aimed at speeding productivity growth and slowing wage increases is required. The various business tax incentives for capital formation, especially accelerated depreciation, would be of help over the longer run. So would a TIP (Tax-Based Incomes Policy).

Third, the central bank has to hold a given course of monetary policy long enough to observe some tangible results before intensifying restriction or accelerating ease. With six-to-nine month lags in effects behind turns toward restriction and longer lags in response to ease, too early action in extending restriction or loosening has plagued the Federal Reserve in the postwar period, helping to create alternating periods of severe recession or too strong an expansion.

Finally, so long as the inflation of a business expansion is not a generalized problem of excess demand, the central bank should avoid the severe squeeze on liquidity that has been applied in all the crunch episodes since 1955. A restrained monetary policy is clearly an essential ingredient to limiting inflation, but the payoff on inflation from the periodic bursts of severely tight money and credit crunches has yet to surface.

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[5] The TIP notion is not new, although the program suggested is a new variant. The preliminary results from a study on tax credits for wage reduction reported here is the first attempt to a quantitative analysis, however. The major studies and proposals on TIP include Henry C. Wallich and Sidney Weintraub, "A Tax-Based Incomes Policy", Journal of Economic Issues, June 1971, pp. 1-19; S. Weintraub, "An Incomes Policy to Stop Inflation," Lloyds Bank Review, January 1970; Lawrence S. Seidman, "A New Approach to the Control of Inflation," Challenge, July/August 1976, pp. 39-43; Abba P. Lerner, "Stagflation - Its Cause and Cure", Challenge, September/October 1977, pp. 14-19; Aurth M. Okun, "The Great Stagflation Swamp," Challenge, November/December 1977; S. Weintraub, Capitalism's Inflation and Unemployment Crisis: Beyond Monetarism and Keynesianism, Addison-Wesley, 1978; L. S. Seidman, "Tax-Based Income Policies," Brookings Papers on Economic Activity, 1978:2, pp. 301-348.

The CHAIRMAN. Thank you, Dr. Sinai.

It's fascinating that both Mr. Willes and Mr. Sinai seem to come down on pretty much the same prescription as to what we should do now. That is, a steady policy, pursuing not much different from the policy the Fed is pursuing now, yet you both disagree between each other very sharply in what the Fed has done up to date.

Mr. Willes, as I understand, thinks the Fed has been about right, and you think the Fed has been seriously wrong.

Mr. SINAI. One cannot do anything about what's happened in the past at this point.

The CHAIRMAN. I know, but if your analysis is correct, it would seem to me that it would follow now, with unemployment having increased more rapidly in April and May than any 2 months in our history, with the leading indicators being almost unanimously down in April and down again in May very sharply, with the growth in the economy falling more rapidly than it had in any month since the Depression, all that would suggest a more expansive policy. But you're very concerned that this might feed inflation.

Mr. SINAI. Well, I am concerned that it would hurt the backdrop for other policies that I think are important to employ against inflation. The central theme I would argue is that monetary policy will not do much to solve what is left of our inflation problem and other policies mainly in the tax area would be more fruitful.

The CHAIRMAN. So that you would feel that we have to maintain a steady restrained monetary policy to fight inflation. You don't think it's contradictory, however, to go the other way with a fiscal policy that would try to overcome the recession and reduce unemployment?

Mr. SINAI. This is a question you asked earlier on the matter of tax policy. It is appropriate to cut taxes for 1981, but it would be inappropriate to cut taxes in the same fashion as has been done before in previous recessions. It would be a mistake to pump prime either through Government spending or across the board personal income tax cuts at this time.

What is really needed on the tax side is a new approach which selectively uses taxes to target on the key sources of inflation rather than to stimulate across the board.

TAX BASED INCOMES POLICY

The CHAIRMAN. A TIP kind of cut?

Mr. SINAI. Yes.

The CHAIRMAN. The kind Dr. Wallach and Arthur Okun recommended?

Mr. SINAI. Yes. There is an analysis of that in the statement. What one does about inflation—it's like any illness. What a doctor does, right or wrong, really depends on what you think the cause is. And because so much of the inflation is coming from wage increases a large productivity drop and also from shocks like the food drought in the Southwest and oil and energy——

The CHAIRMAN. Let me just interrupt to say that I agree that the TIP approach makes sense and I would like to see it. We are not going to do it, however. It's clear that there's very little support in the Congress. The Ways and Means Committee doesn't seem to be interested in that at all. They are interested in other kinds of tax reductions, including the so-called 10-5-3 reduction and perhaps an incentive for saving by exempting part of interest income from the income taxes—that kind of thing. How do you feel about that?

Mr. SINAI. Those are all worthwhile kinds of tax policies. The right kind of tax policy at this time would be anything that would help to reduce business costs. So, for example, giving credits for personal income taxes to offset the social security tax rise, or indeed what would be better would be really to reduce the social security taxes if the general funding would permit it—that would be a more effective way of stimulating consumer demand. It would be a more anti-inflationary way to stimulate consumer demand than to have an across-the-board reduction in personal taxes.

The CHAIRMAN. Let me ask Mr. Willes to respond to that. I take it you seem to feel we ought to follow a restrained fiscal policy and monetary policy and we should not reduce taxes. You said that was very important. I take it that you do not favor an increase—maybe I'm wrong—do not favor an increase in spending. In fact, you would agree, I take it, if you're going to balance the budget you have to try to balance the budget or move toward a lower deficit, that you have to restrain spending too. What would you do, if anything, to overcome the very, very serious and deep recession we are in and moving into a deeper one?

Mr. WILLES. It seems to me one of the real issues we face is how much do we really know and what can we really do to impact on the environment around us and what can't we do. And I'm always amazed by those who suggest that we really have a pretty good handle on how our economy works and we know how to intervene with $10 million here or $20 million there to make the system work a lot better, and I guess I'm convinced, after having studied it for a long time and been a policymaker for some time, that the fact of the matter is we just don't know all that much about how the system really works in the sense that we don't know how to intervene in a systematic way in the economy to improve the unemployment rate on average, for example, to improve the rate of output on average, and those sorts of things.

Where I come out—and I have a very simple-minded view about what we know—some people say I have a very simple mind, which is probably also true—but it seems to me if you were to canvass the economics profession you would find that there's general agreement that inflation on average is a monetary phenomena. That if, if you have more money in the system, you get more inflation. If you have less money, you get less inflation.

Sure, there are shocks of all kind, short-term things, but those tend to be temporary. The first thing is that inflation is essentially a monetary problem and that's attracted widespread support I think now and it's that notion that says what we ought to do is systematically reduce the rate at which money grows and take inflation out of the system.

The second proposition it seems to me which is substantially less universally agreed to but I think in time will be, and that is that our ability to intervene in the economy, to finetune, to reduce recession, to reduce unemployment and so on, is very, very limited.

In fact, there's one line of argument that says it's almost impossible, given our current state of knowledge, to do that.

If that's the case, then we are forced into a position where we simply can't take these computer runs and figure out, well, we ought to cut $10 million to help ameliorate the recession and that sort of thing.

So where I come out is we ought to do what we can carefully and systematically against inflation. Beyond that, the economy is resilient. It's buoyant and it will begin to come back on its own. It will come back on its own and it will come back at the same time that we can continue to take inflation out of the system.

Now finally, on the specific question of a tax cut——

The **Chairman**. Before you get away from that, you're very optimistic to think it will come back on its own. Everything seems to be getting worse. As Dr. Sinai pointed out, and I don't think anybody can deny that he's right, as we come out of this recession the level of inflation, given the level of unemployment, is going to probably break all records. So we're going to start from a level of inflation which is quite high and the prospect that we can reduce unemployment by any significant amount while at the same time restraining inflation seems to be beyond the reach of any of you three gentlemen at least. Maybe I'm unfair.

TRADEOFF

Mr. **Willes**. Well, we used to have the notion—some people still do—that there's kind of a nice tradeoff between inflation and unemployment. If we're willing to tolerate a little more inflation, we can have a little less unemployment and so on.

The **Chairman**. There is some tradeoff, is there not? There is some tradeoff. Certainly as you get to high levels of unemployment, the real increase in wages tends to fall off somewhat. It's somewhat easier for employers to pay less wages. It's harder for employees to demand higher wages. And that underlying inflation rate tends not to rise quite as rapidly in a period of recession as in a period of fuller employment. Isn't that correct?

Mr. **Willes**. Well, that is correct. The question is, Is that the kind of tradeoff which persists over time and which you can exploit from a policy point of view to make the economy function in some way that you determine to be desirable? And what we found out is over the last 15 years that tradeoff that we thought we could count on had essentially disappeared and, as a result, we have ended up precisely as you say, in the current environment with not only higher inflation but higher unemployment than any of those earlier estimates would have indicated we would have.

Well, if you can have that happen to you going out, there wouldn't seem to be any reason in principle why if you're patient enough and careful enough that you can't have the thing come back in the other way. That is to say, if you follow the kinds of careful, prudent monetary and fiscal policies we have been talking about, sure, in the short run you're going to have higher unemployment than you want. We have had an economy that's been twisted out of shape and that's one of the consequences, but if we'll go with that carefully but persistently so the policy has real credibility, there's no reason in principle, in my judgment, why you can't have inflation finally begin to come down and permanently come down and at the same time have the economy generate the kinds of employment and jobs that we are all anxious to have.

The Chairman. Why would you disagree with Mr. Parry who said that he favored a tax reduction and you opposed a tax reduction, recognizing that taxes will increase because of inflation? Some people argue there's a tax increase that we're going to have this year or next year or two of about $90 billion because of the fact that there's an inflation bracket creep and you're pushed into a higher and higher income tax bracket. There's a tax also on corporations elsewhere in the economy that gives you an automatic tax increase without any legislation on the part of the Congress.

Aren't you, in saying to hold steady on the tax situation, really accepting a tax increase and a restrained fiscal policy at a time of rising unemployment and with an outlook of increased recession?

Mr. Willes. It is perfectly true that taxes have risen and are continuing to rise very sharply. It's also true, in my judgment, that spending, which is the real tax, is also rising very sharply.

I'm all in favor of a tax cut if we'll cut real taxes, which is the amount which the Government extracts from the economy which is the amount which the Government spends. If we're not willing to do that, and certainly as unemployment rises it's very unlikely——

The Chairman. As I understand it, that was part of Mr. Parry's position too, that you should cut spending.

Mr. Willes. If a cut of taxes is coupled with a cut in spending, then I would be 100 percent for it.

The Chairman. Then you favor a spending reduction if we can achieve it?

Mr. Willes. I think it's very important.

The Chairman. Where can it come from?

Mr. Willes. There are many places where it could come.

The Chairman. Well, I know, but the difficulty is that everybody is for reducing spending but when you get down to the details they say we can't cut the social security expenditures, for instance, which is an enormous part of our expenditure. Everybody agrees we can't. Ronald Reagan agrees we can't. Nobody says we can cut that. Some people say we have to increase our military spending sharply. That's the one area that's most capable of congressional control and there's an all-out drive on the part of Democrats and Republicans to increase it.

Mr. Willes. I think the social security spending can be cut. I think I'd start with the Department of Energy. You could save $20 billion and solve the energy problem at the same time. I think there are lots of areas where you can cut spending if we have the courage to do so. But if we're unwilling to do that—and that was the point I was making—then it seems to me that we have to face——

The Chairman. How would you cut social security? We have contractual obligations to 36 million people. How would you cut that?

Mr. Willes. You would have to change the obligation. We have committed ourselves to pay more than we can afford to pay.

The Chairman. What you would do then, I take it, is to reduce the escalator, the cost of living escalator?

Mr. **Willes**. That's the best place to start.

The **Chairman**. So the people on social security would get less in real income as the inflation continues; is that right?

Mr. **Willes**. Well, if you're really serious about it and effectively cut spending, inflation will not continue. So rather than getting less, they would end up getting more.

The **Chairman**. The great majority on social security are in the poverty class. Their incomes are below $5,000 for a couple.

Mr. **Willes**. And inflation hurts them more than——

The **Chairman**. And if we follow your proposal they would be in worse shape, wouldn't they?

Mr. **Willes**. No, they would not.

The **Chairman**. Why not?

Mr. **Willes**. Because if we could really effectively deal with inflation, which is the biggest tax of all that they pay, their real income would not decline.

The **Chairman**. What you've got to do, to be realistic about it, is to find a way of dealing with inflation without cutting their real income, since it's so low anyway.

Mr. **Willes**. Well, something has got to be cut someplace, Senator, or we'll never get off the bandwagon.

The **Chairman**. I agree with that, but that's why I'm asking you where to cut it. Dr. Parry.

Mr. **Parry**. Well, I think the cost-of-living adjustment should be modified. It doesn't seem to me that it was the intent of Congress that if, for example, wages were rising 9 to 10 percent in the period ending March 1980 social security recipients would have their benefits go up 14.3 percent. I think that there definitely is room to rethink the issue of how one ties benefits to the cost of living.

I would also point out that logically if we believe mandatory retirement is something that should be pushed off to an older age, then we should take time to look at the issue of when full social security benefits should be paid too.

The **Chairman**. Dr. Sinai.

Mr. **Sinai**. It would be a good idea to reindex social security payments to a more appropriate cost-of-living index than the Consumer Price Index. I think we don't have a tremendous amount of moving going on by our aged population, but——

The **Chairman**. CPI is very badly flawed. It is distorted because it makes the assumption that everybody buys one-twelfth of a home each year and the result is that the colossal increase in mortgage rates and the terrific increase in home prices distort the Consumer Price Index very badly.

However, now that interest rates are going down on mortgages and you may not get the same rise in prices on housing, if you shift to another system you're going to get probably a greater increase in social security than if you stick with what you've got, badly flawed as it is.

Mr. **Sinai**. Actually, you're probably right. It's only this one curious situation where there was this large divergence between the CPI and the other indexes, but I think it's kind of small potatoes in terms of what you would save on that.

DISINFLATIONARY SHOCK

The real answer, or the most likely possible answer to inflation is to somehow engineer a disinflationary shock to the economy. You see, if you look over the last 10 years, we have had a serious of exogenous inflation shocks, whether it was the oil embargo or the tremendous change in the price of energy and oil in 1973–74 or the worldwide increase in commodity prices. These external shocks ratcheted our inflation upward and presented the central bank with an impossible dilemma of what to do with those external shocks.

We have to somehow engineer a "disinflationary shock" and that is the promise of a program like TIP and it's very regretful that it has now been dropped by the wayside because there are variants of TIP that would be very simple to put into effect.

The CHAIRMAN. You could put it into effect without losing any revenue as a matter of fact. What you could do is provide for a penalty, as Dr. Wallich proposed, for wage increases that exceed the standard and would also provide a reward for the wage increases that were below and reward both the working person and the employer.

Mr. SINAI. So I really come down to thinking of that as one means of engineering it.

The CHAIRMAN. The argument you get on that one is it's wage/price controls by another name. To some extent, it is.

Mr. SINAI. I don't believe that.

The CHAIRMAN. Sure it is. After all, the most effective kind of control we have in our system in many ways is through the tax system, and if somebody is going to increase wages above the standard, above the control level, and you're going to sock them with a tax increase if they do it, it's just like a fine. That comes very close to a wage control.

Mr. SINAI. But it has quite a different effect than if you simply froze or legislated wage and price controls. It would go through the market mechanism rather than interfering the way wage and price controls do.

The CHAIRMAN. I want to get into these monetary questions in a minute.

Mr. WILLES. I just wanted to make one comment on the TIP question. I think there's a risk of being very badly disillusioned with a policy like that. If you follow it through, it turns out to be a tax on labor and therefore a disincentive to employment, but more importantly, if we put the TIP in when it was originally proposed with the expected rate of inflation that was originally forecast and then kept the commitments which TIP had made, it would have increased government spending and therefore the deficit by about $50 billion because inflation was substantially higher than forecast. As a consequence, it seems to me that's a very risky and tricky kind of arrangement which I would hope we would stay away from, and I'm pleased to hear that you think it will not be implemented.

The CHAIRMAN. We're going to have a tax cut anyhow. You might as well have one that is anti-inflationary.

Let me ask you this, Mr. Willes. The key monetary policy aggregate seems to be M1-B, currency, demand deposits, and other checkable deposits. Last February the Open Market Committee set a target range of 4- to 6.5-percent growth for 1980 for that variable. For the first half of this year the actual growth was only 1.8 percent. That was far, far below the lower range. So the Fed has considerable latitude on the upside to permit faster growth of M1-B and still meet its objective.

Our calculations indicate that growth between 6.5 and 11.5 percent would be consistent with the 4- to 6.5-percent range for the year.

Now it seems to me the upper end growth of 11.5 percent growth in M1-B would be inflationary and even the midpoint of 9 percent would be questionable. It would be difficult to bring that 9 percent down to an acceptable level in 1981. So it might be best to take aim at the lower end which at 6.5 percent by historical standards is fairly rapid growth.

If you were back on the Open Market Committee, where would you have the Fed set its monetary growth target for the remainder of the year?

Mr. WILLES. I would agree very much with your position. I think the desirable target would be the lower end of the range. If it got pushed to the center I wouldn't find it too distressful, but if it went beyond the midpoint I would be.

The CHAIRMAN. Where should they be aiming for 1981?

Mr. WILLES. I think toward the lower end.

The CHAIRMAN. Mr. Parry?

Mr. PARRY. I would agree that aiming for the lower end of the range for this year would be appropriate. I think the Federal Reserve would have difficulty reaching the lower end of that range in 1981, if nominal demands are growing on the order of 12 to 13 percent.

The CHAIRMAN. You mean getting up that much?

Mr. PARRY. No. I think there's going to be a risk that growth is going to be higher than that. If nominal demands are growing about 13 percent and with velocity at an historically high rate, you probably would get growth of M1-B somewhere in the range of 5 to 5.5 percent. I think they're going to have great difficulty keeping it within the range of 4 to 6.5.

I should also point out a technical matter. There will be some switching out of financial assets that are interest bearing into interest bearing checking accounts associated with the introduction of NOW accounts. That's likely to mean that M1-B will be growing more rapidly. So I really think when you look at M1-B at the end of 1981 it's quite likely that it will grow at least within the range of 4 to 6.5 percent and that the Federal Reserve will be unable to reduce that range.

The CHAIRMAN. Dr. Sinai?

Mr. SINAI. I wouldn't be terribly concerned if the growth rate in the second half of the year were to creep up between the midpoint and the upper target. That probably won't happen anyway because the economy is weak enough to keep the demand for money low.

The CHAIRMAN. That's a little ambiguous. You mean if it crept up in the last——

Mr. SINAI. I wouldn't worry about it unless it persisted for 3 or 4 months. In other words, if you got 10 percent for a month or two in the second half of the year in M1-B growth, I wouldn't worry about it. But if it persisted for 3 or 4 months, it would suggest the economy is rebounding back stronger than expected.

With regard to 1981 and extracting from the shift of NOW accounts which is bound to make M1-B grow more rapidly, I do think the Federal Reserve should take this opportunity to lower the longrun growth targets, and I hope that Chairman Volcker will actually do that tomorrow. This is a good opportunity to do it because the economy is weak and it will reaffirm a commitment to an anti-inflation stance.

CONSISTENT, STEADY MONETARY POLICY

The **Chairman**. I think all of you would agree with the position I'm going to enunciate now, but I'm not sure and I want to be sure you do.

In the past several years it has become increasingly clear that the fine-tuning approach to economic policy is extremely difficult during a period of rapid inflation. We may only be able to reduce inflation and unemployment, increase productivity and investment, and generate satisfactory economic growth with policies that are steady; that is, that are aimed at longer run stability, without wide swings to take account of short-run problems. With regard to monetary policy our best shot at price stability can only be achieved if we proceed to gradually and steadily reduce the rates of growth of the monetary aggregates to levels consistent with the economy's long-run potential to expand output and productivity.

Do you all agree with that steady approach? You seem to, even though you had different analyses of the present situation and past performance. I take it you all agree we should follow a consistent, steady monetary policy rather than one that tries to meet problems of the moment?

Mr. **Willes**. Absolutely.

Mr. **Parry**. I would agree.

Mr. **Sinai**. Yes.

The **Chairman**. Now, Dr. Sinai, we have come through a period when interest rates have declined very dramatically in a short period of time. However, during the past several weeks rates have stabilized and fluctuated in a narrow band.

Has the Federal Reserve's decision to permit interest rates to fluctuate more widely than in the past been successful, or did the rapid increases in rates this spring followed by rapid declines recently increase instability in the financial markets, thus adding to our economic problems?

Mr. **Sinai**. Well, it's really a two-part question. The first part is did the new Fed policy result in what the Fed said they wanted, which was more volatile movements of interest rates, and the answer is yes. Any analysis of variation of movements in typical interest rates shows that since October 6 we are getting three to four times greater variation of interest rates than before. So clearly the Fed has been trying to change reserves to affect monetary growth and they have been letting interest rates fluctuate relatively freely.

The second part of the question is, has this been beneficial or harmful? It's still a little early to be sure, but I would have to conclude at this point that it really has been counterproductive, that the tremendous upswing of interest rates between October 6 and mid-March played a large role in causing the deep downturn that we are now in and, curiously, we then had a total erasure of those rises in rates in a very short time. I doubt that such volatility really helps.

The CHAIRMAN. That's right, and it certainly had a devastating effect on the homebuilding industry when the mortgage rates came up so high. We had people come in here from almost every State and sing the blues, and they were right. The housing starts went below a million in April and they recovered, but they are still extraordinarily low. But at the same time, if we followed another policy, as you seem to imply, wouldn't we simply have exacerbated inflation?

Mr. SINAI. No, I really don't think so. In fact, the new policy may have exacerbated inflation because of how mortgage rates affect the Consumer Price Index.

The CHAIRMAN. In the short run, but you seem to be contradictory now. You say we should have a steady policy and a policy of reasonable restraint.

Mr. SINAI. I think a steadier policy in the growth of reserves.

The CHAIRMAN. They certainly followed a steady policy from October through April, haven't they?

Mr. SINAI. No. There isn't any——

The CHAIRMAN. Steady policy restraints?

Mr. SINAI. Up until late April. Between late April and June, the Federal Reserve moved to a rather aggressive posture of easing in terms of the provision of reserves, in terms of their own standard of judging how easy or tight they are. What I'm saying is that the new Fed policy and the operating mechanism were the right thing to try in October, but we need now to modify it. It may be that the answer is somewhere in between the new Fed policy and where they were before. The answer certainly isn't fixing interest rates and moving them by a quarter of a percentage point steps every month or every 2 months, which was the previous policy, and the answer perhaps is not total movement of bank reserves with interest rate fluctuations left to wherever they go.

My suggestion to the Fed is to consider modifications in the way in which the new Fed policy is implemented that would move toward a more central position that might narrow the range of growth of bank reserves so it doesn't fluctuate between minus-30 and plus-30 over a 4-month period or even perhaps narrow the range for fluctuations in the Federal funds rate to 3.5 percentage points rather than 5 or 6.

The CHAIRMAN. Mr. Willes, what's your answer to that?

Mr. WILLES. It seems to me, while we may not have learned much over the last 20 years, one thing we learned, if we try to sharply moderate fluctuating interest rates, we lose control over the interest rates aggregates.

The CHAIRMAN. That sounds like fine-tuning.

Mr. WILLES. If we really want to control aggregates and make them steady. We have not done a notorious job of trying to figure out where they will go. It seems to me the fluctuation of interest rates we have had is a cost we have to pay as we learned to use these new procedures, and it's a cost we have to be willing to pay.

FED TARGET RANGES

The **Chairman**. Tomorrow Chairman Volcker will announce the new target ranges for monetary aggregates for 1981. He will be before this committee. What will be the market's reactions to ranges that are either the same as 1980 or even slightly higher, and how can we strengthen the perception of a steady monetary policy? Should the Fed announce multiyear targets?

Mr. **Willes**. I think it's very important for the Fed to announce targets which are at least as restrictive as they have been in the past, and I think it wouuld be very helpful if they would announce multiyear targets. The Fed has always resisted that, wanting to maintain flexibility to respond to changes in the economy around them. My own assessment is that that kind of flexibility has not served us very well and we do far better to lay out a long run path and then stick to it.

The **Chairman**. Mr. Parry, would you comment on that?

Mr. **Parry**. I think if they announce the same target range and there is unfavorable reaction in the financial markets, that would be very unfortunate; but I don't think it would be the Fed's error. It seems to me, as I have mentioned, that it's going to be extremely difficult for them seriously to reduce the range and hit the targets. So I think if they were to explain why 1981 is a somewhat poor year to reduce the targets and that they do have plans to reduce the growth rates of the aggregates over the longer term, it would be an appropriate position for the Federal Reserve in 1981.

The **Chairman**. Mr. Willes, it's very likely that we will have a large budget deficit this year and next year, especially if we get a tax cut in the order of magnitude of $25 or $30 billion. This committee has been told many times that deficits make it more difficult for the Federal Reserve to hit their monetary targets. Moreover, even if monetary policy can continue to be restrictive in the face of expansionary fiscal policies, the burden will fall on savings and investment.

Do you agree, in the face of expansionary fiscal policies, that not only is the Federal Reserve's task harder but it might be impossible?

Mr. **Willes**. A large Federal deficit puts upward pressure on interest rates which under the old operating procedures made it very difficult for the Fed to hit its monetary targets because we resisted rapid increases in short-term interest rates. If the Fed is willing to stick to its new procedure and allow interest rates to go pretty much wherever they need to go, an increase in the deficit would not make it more difficult for the Fed to hit its monetary targets.

However, I would simply restate that that deficit itself would be inflationary and in part undermine what the Fed was trying to accomplish.

The **Chairman**. But it would not be harder to hit its targets?

Mr. **Willes**. I don't think so, if it's willing to allow short-term interest rates to move around.

The **Chairman**. In effect there would be higher rates of interest and therefore no moneys for the farmers and small businessmen and others and heavier unemployment perhaps in those industries that are interest rate sensitive such as homebuilding and construction and automobiles?

Mr. **Willes**. It depends on the level at which they fluctuate.

The **Chairman**. Well, isn't it inescapable if we have a big Federal deficit and the Federal Government is borrowing more money it's going to drive up interest rates, and isn't it inevitable that the higher rate of interest means all other things being the same you should have a lower level of home construction, a lower level of automobile consumption, and so forth?

Mr. **Willes**. No, it's not inevitable. It depends on how high it goes and how quickly it gets to that level. If interest rates move up as they did for the last 2 or 3 years, relatively slowly until the last 6 months, financial institutions were able to acquire funds and relend them at higher rates and borrowers were willing to borrow and nothing essentially happened to the housing industry. If they shoot up very precipitously in the short run——

The **Chairman**. The housing industry did go into a nosedive in the last 3 or 4 months. We're underbuilt. We need a great increase in housing. We should be building 2.5 to 3 million housing units a year. We are building less than 1 million a year. We have done well in the past when we've built 1.8 million; that's considered a good year. Your monthly payments depend on your rate of interest more than anything else by far. The rate of interest is about three times as important as everything else on a house right now, isn't that right, a typical 30- or 35-year mortgage, if you have to slug away at a 11, 12, 13, or 14 percent mortgage rate. Figure out what the interest is compared to the cost of the house and the land and everything. It's about three times as much for interest.

Mr. **Willes**. Just to make your arithmetic, if you pay a 13-percent mortgage and you expect 10 percent inflation and you're in a 30-percent tax bracket and therefore you can deduct your interest payments on your income tax, the cost of that mortgage over 30 years is very small, and that's why consumers——

The **Chairman**. Go back over that arithmetic. You're in the 30 percent tax bracket. What's your interest rate?

Mr. **Willes**. If you pay—well, let's take 10 percent because the math is easier that way, but you can do it with 13 percent. You're in a 30 percent tax bracket. The aftertax cost to you of that 10 percent mortgage is 7 percent because you can write the interest off your income taxes. So the aftertax cost of that 10 percent is 7 percent.

In addition to that, however, if you had a 7-percent inflation rate and you had a 10-percent mortgage, you paid back those funds each year which are worthless in purchasing power by 7 percent each year, which means that what you have to give up in terms of buying other goods and services to make that interest payment is 7 percent less each year. So if you have a 10-percent mortgage rate and you're in a 30-percent tax bracket, inflation is 10 percent.

The **Chairman**. You made a terribly frightful, hideous kind of assumption. You've assumed we are going to have 20 percent inflation for the next 30 years. If we have that, we're really in desperate shape.

Mr. **Willes**. I agree with that, but I think that's the standard economist's——

The **Chairman**. If somehow we can break our inflation problem and go down to 2 or 3 percent and you're left with a 12-percen mortgage rate for those 30 years——

Mr. **Willes**. Most mortgage contracts in most States you can refinance after a reasonably short period of time.

The **Chairman**. There are a few that way, but many are not.

Mr. **Willes**. You're thinking of a variable rate mortgage, but in most contracts after a short period of time—in Minnesota, for example, the next year, if you want to, you can simply close out the contract and take another mortgage. So you can get out from underneath those payments.

The **Chairman**. Well, Minnesota is peculiar. It's a pretty good State, a great State, the second best State.

Mr. Sinai, it's likely that as we move through the current recession the rate of inflation will decline, but the underlying rate may not fall below 9 or 10 percent. Long-term interest rates may not fall much further from their current levels even if short-term rates decline substantially further.

What does your analysis suggest about the future course of long-term mortgage rates?

CHANGES IN MORTGAGE MARKET

Mr. **Sinai**. With that rate of inflation we would not see long-term bond yields below double digit figures and as far as mortgage rates go we would not see mortgage rates much below 11 percent. What is changing in the mortgage market now is the much more variable cost of funds the thrift institutions pay with the lifting of regulation Q ceilings and the like, and the advent of the 6-month to 30-month instruments. The cost of funds to the mortgage lenders is now at a higher plateau than ever before, so it means the mortgage rate between the inflation and the cost of funds would be at a much higher level than we have ever seen in our history.

The **Chairman**. And how far does your forecasting go? When you say a higher level than we have seen before—5 years, 10 years?

Mr. **Sinai**. You can pretty well fix the bond yields by whatever assumption you make on inflation. So if 9 percent on average is our inflation rate for the next 5 years, then on average, we'll have at least double digit figures for top quality corporate bond yields and the mortgage rate will be even higher than that. It would be on the order of 11 percent.

The **Chairman**. For how long?

Mr. **Sinai**. As long as the average rate of inflation is in the 9-percent area.

The **Chairman**. I'm asking how long that is. How long are we likely to have that? Give us your forecast. I realize that the further you get out, the less reliable and useful your forecasts are, but I'm asking whether you have any forecast.

Mr. **Sinai**. We do. We are looking at inflation rates on the order of 6 or 7 percent in the mideighties. Now somehow I'm optimistic that we will find a way through policy to do better on inflation.

The **Chairman**. I wish I'd brought it with me. I had a fascinating newspaper clipping which I'd like to have you distinguished economists comment on. I don't have it with me. It indicated that if Governor Reagan is elected we will have one level of inflation and one level of unemployment. If President Carter is reelected, we'll have another level; and if John Anderson is elected we'll have another level. What that showed is that Reagan would have the lowest level of inflation, the lowest level of unemployment, the fastest growth compared to Carter compared to Anderson. Let me just ask quickly if you gentlemen would give me your opinion. I don't know if you're Republicans, Democrats or Independents. What's your opinion of that kind of analysis?

Does it have any substance at all? Can it mean anything or do you think it's just political propaganda? We'll start with Mr. Willes.

Mr. **Willes**. I used to be able to dodge those kinds of questions but I can't anymore. I don't think it has any substance at all. What happens to the inflation rate and unemployment rate is a function primarily of Government policy and that depends not only on the President but on the Congress.

The **Chairman**. What was that?

Mr. **Willes**. I said, what happens to the inflation rate is primarily a function of Government policy and that's a function not only of the President but of Congress.

The **Chairman**. Well, you have ducked it again. Supposing instead you tell me whether you think the policies advocated by Governor Reagan and President Carter and Congressman Anderson would make any difference, in your view, if they could be applied. Would we have about the same kind of economic outlook regardless of who's the President?

Mr. **Willes**. I'm not sure what President Carter's policies would be and I'm not sure what the policies of the others would be either, so I don't know.

The **Chairman**. Well, you've ducked it again. All right. Mr. Parry.

Mr. **Parry**. It's my view that for calendar year 1981 it's not likely to make much difference because in large part the budget will be fixed by the current administration. The effects of a change in the administration, if this should occur, wouldn't be very large.

The **Chairman**. Throughout the calendar year 1981?

Mr. **Parry**. Yes, I don't think the effects would be that great. I'm also impressed in reviewing postwar economic history that circumstances determine policy as much as particular individuals. We know, for example, that people who were in office and were considered quite conservative were those that embarked upon a wage and price freeze and the imposition of import surcharges. We also know those who are considered to be quite liberal in their policies were those that reduced the corporate income tax rate.

The **Chairman**. Incidentally, this forecast was for a period through 1985 for each of the three candidates.

Mr. **Parry**. I have seen that study. I really did not put much credence in it. It seemed to me there was as much religion in that study as there was economics.

The **Chairman**. That was my reaction but I wanted to get yours.

Mr. **Sinai**. I'm sure that wasn't a DRI study. I was away for 2 weeks.

The **Chairman**. Have you made such a study?

Mr. **Sinai**. We have begun to analyze the Reagan tax proposal, the 10-5-3 and the 10-percent across-the-board personal income tax reduction, and curiously, it looks to me, if you're anti-inflation, you really have to go with Carter because Governor Reagan's policies are very stimulative, and so far from what he's said, they are very stimulative and would be more inflationary.

The **Chairman**. So the Republican proposals to have lower unemployment and higher prices and the Democrats is to——

Mr. **Sinai**. A reversal of what people typically think would be the case.

The **Chairman**. OK.

Mr. Willes, from time to time monetary policy decisions have been largely determined by international developments relating to the value of the dollar. I think that we would all like to have the value of the dollar stabilized, but not at the expense of the rest of the economy. Market participants have suggested that one reason why interest rates have not been permitted to decline further is that the Federal Reserve is concerned that relatively lower interest rates here than in Europe would exacerbate the decline in the value of the dollar.

In your judgment and experience, how much weight does and should the Open Market Committee give to the maintenance of a stable dollar in deciding monetary policy?

Mr. **Willes**. There's no question that some members of the committee are very concerned about rapid declines in interest rates and the impact on the dollar. I think as a matter of practice the foreign exchange value of a dollar has had a relatively limited impact on the actual policies that have been pursued. In my judgment, it turns out that the policies don't conflict anyway. The primary thing that will determine the strength in the dollar will be a reduction in inflation and the primary target that the Fed ought to pursue is a reduction in inflation.

The **Chairman**. About a week ago I sent each of you a copy of Senate Concurrent Resolution 106 which I introduced on July 2 along with Senator Garn. The resolution expresses the sense of the Congress that the Federal Reserve should:

One, adhere to a longrun anti-inflation policy until substantial progress has been made in reducing inflation;

Two, pursue policies over the remainder of 1980 and 1981 to encourage reductions in the rate of inflation and expansion in the rates of growth of the monetary and credit aggregates appropriate to facilitate economic growth; and

Three, work toward establishing longrun rates of growth of money and credit consistent with the economy's longrun potential to expand output and productivity by gradually reducing the rates of growth of the monetary and credit aggregates in a firm and stable manner.

I'd like to have each of you comment on this resolution and indicate whether you would recommend that it be passed.

Mr. Willes, I'd also like you to comment on whether you believe your former colleagues at the Fed would be supportive of this and would in fact take a longer run approach to monetary policy because of this resolution?

I might say that the Fed has 535 bosses in effect and is independent of the President. As you know, it's an arm of the Congress in the sense that the money powers by the Constitution were given to Congress. We delegate that policy to the Federal Reserve. We don't like to interfere, but this resolution was called for by both Burns and Martin and I think it's a wise one, but I'd very much like to get the views of each of you gentlemen.

COMMENTS ON SENATE CONCURRENT RESOLUTION 106

Mr. **Willes**. I have no trouble at all with the resolution. I think in using it as a way of putting the Congress clearly on record that it supports and encourages a steady, long-term, anti-inflation policy it's done a very positive thing.

As to the reaction of my former colleagues, I would never want to speak for them, which is a great relief to them. I would simply say that the system has resisted in their own internal discussions the setting of long-range targets because they were concerned that that would unduly hamper their flexibility to meet changing economic conditions as they emerged.

I personally expressed, both within the system and have expressed outside of the system, that that is incorrect; that we would be far better served if we did set longrun targets and that we then follow through to make sure we get those longrun targets.

Mr. **Parry**. I would support the resolution. I think in particular that the first part of it which calls for them to adhere to a longrun anti-inflation policy until significant progress has been made in reducing inflation is an important mandate from Congress and I'm not so sure they have had such a strong mandate in the past.

Mr. **Sinai**. I think it's a resolution I would support and the only caveat would have to do with the Fed's independence in terms of the formation of monetary policy and the only other comment I would make is——

The **Chairman**. Well, as I say, that resolution was put together by Senator Garn and myself after we had heard this very clear statement by both Martin and Burns, as well as a number of other distinguished former public officials, seven Democrats, six Republicans, all with very strong experience either in the Congress or mostly in the Federal Reserve or in the Treasury Department.

Mr. **Sinai**. Sure, and the only other comment which really is not at all a criticism of it is that I do think that focusing a great deal on monetary policy and inflation does take us a bit away from what really is causing most of the inflation, and it would be nice to see more concern with dealing with the wage increases that are in excess of productivity growth, because I think that until we do that—and I don't think the answer will be monetary policy— until we do that, until we focus on that and measures to get at wage increases——

The **Chairman**. Are you familiar with the policy statement made by the Anti-Inflation Committee?

Mr. **Sinai**. I have the reprint here.

The **Chairman**. They had a whole series of recommendations. This is one of them.

Mr. **Sinai**. And of other kind of measures as well, but I still think we are not coming to grips with what fundamentally is causing most of the problem—wage increases in excess of productivity growth and external inflationary shocks that keep on being imposed on us from without.

The **Chairman**. Let me finish with one question that I asked at the beginning and you didn't have a chance to comment on it, none of you did. It's reported—and maybe I'm unfair—it's reported that Governor Reagan has been supportive of a return to the gold standard. Lawrence Kudlow, chief economist for Beare-Sterns also is supportive of that. A number of Senators have spoken to me on the floor about it. I don't know how much support it has. I doubt if it has anything like a majority support, but it's an interesting element.

The argument, of course, is with a gold standard we have a clear, sharp, unquestionable discipline in our monetary policy and the argument on the other side is it could have a devastating effect if we returned to a gold standard driving us into another depression of the 1930 type. But it is one way of trying to fight inflation. I'd like your views on that.

Mr. **Willes**. I think it would be a major mistake from two points of view. One, it's just a real waste of real resources. Essentially what you do is take real resources, dig up gold, take more real resources, transport it someplace else, take more resources, dig another hole, and take more resources to guard it. It seems like a very wasteful activity to me.

Second, and more important to the problem at hand, if we were on a gold standard, we would have as our monetary base a metallic instrument, a fairly large proportion of which was in the hands of other governments whose interest might at times be hostile to our own.

The **Chairman**. South Africa and the Soviet Union?

Mr. **Willes**. That's correct, and I wouldn't want to surrender—as many mistakes as the Federal Reserve has made, I'd rather trust them than the South Africans and Russians to follow a policy that would be in the longrun interest of the United States.

The **Chairman**. Maybe we ought to be on a silver standard. It would help the Hunts out. Mr. Parry.

Mr. **Parry**. I would strongly disagree with a return to the gold standard. It's too inflexible for our economic system and I think what we need is not a return to gold but better policies.

Mr. **Sinai**. Well, I would concur with both statements. We certainly didn't have a better record on inflation when we were on the gold standard. We had the same problems we are facing today. So I don't think that's the answer at all.

In addition, the price of gold is so highly volatile that we would have a monetary base that would be hard to keep track of.

The **Chairman**. Gentlemen, I want to thank you very much. We are certainly in your debt. You made a very, very useful record and we are grateful. Thank you.

The committee will stand in recess until tomorrow at 10 o'clock.

[Whereupon, at 11:40 a.m., the hearing was recessed, to be reconvened at 10 a.m., Tuesday, July 22, 1980.]

[Briefing materials from the Congressional Research Service of the Library of Congress follow:]

Congressional Research Service
The Library of Congress

Washington DC 20540

BRIEFING MATERIALS FOR MID-YEAR 1980 MONETARY POLICY OVERSIGHT

Prepared for the Committee on Banking,
Housing, and Urban Affairs
United States Senate

by

F. Jean Wells
Roger S. White
Specialists in Money and Banking
Economics Division

July 18, 1980

BRIEFING MATERIALS FOR MID-YEAR 1980 MONETARY POLICY OVERSIGHT

Congressional review of economic policies, including monetary policy, is conducted on a systematic and coordinated basis pursuant to the Full Employment and Balanced Growth Act of 1978 (P.L. 95-523). The Act requires the Federal Reserve to submit a monetary policy report to the Congress twice annually. These reports are to present a review of recent economic trends, a statement of objectives for growth of money and credit, and an assessment of the relationship of the growth objectives to economic goals set forth in the Economic Report of the President. In the mid-year report, objectives for growth of money and credit are to be stated for the next calendar year as well as the year in progress. This briefing document is designed to assist the Senate Committee on Banking, Housing, and Urban Affairs in reviewing the Federal Reserve's monetary policy report to the Congress for mid-year 1980.

The first section contains presentations relating to monetary and financial measures. It includes charts portraying money and credit growth for the year in progress in relation to targets set in February 1980 for this year. A development influencing monetary and financial measures during the first half of 1980 was a series of special monetary and credit restraint programs initiated on March 14 and to be phased out by the end of July. Data pertaining directly to these programs are not included.

The remaining sections present budget data, forecasts for the economy, and data tracing past behavior of selected economic variables. This information is provided to assist the Committee in reviewing the Federal Reserve's plans and objectives for monetary policy as they relate to prevailing economic conditions and to economic goals set forth by the Administration. The Administration's mid-session budget review expected to be released Monday, July 21, will contain revised budget estimates and related economic assumptions and forecasts.

Assistance in preparing this report was obtained from Laura A. Layman, Economic Analyst; Barbara L. Miles, Specialist in Housing; Barry E. Molefsky, Analyst in Econometrics; Arlene E. Wilson, Analyst in International Trade and Finance; Philip D. Winters, Analyst in Regional Economics; and Nancy Drexler, Editorial Assistant.

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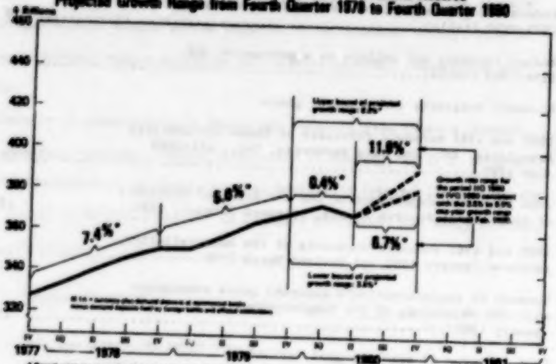
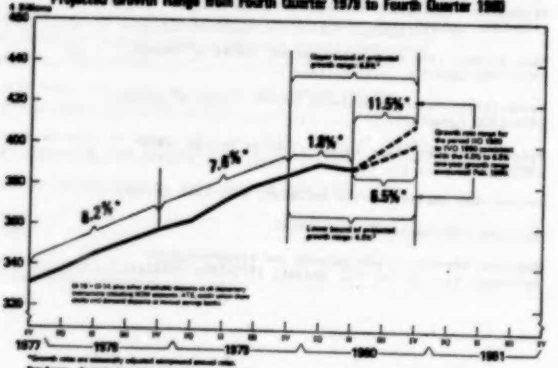
Actual Levels from Fourth Quarter 1977 and Federal Reserve Projected Growth Range from Fourth Quarter 1979 to Fourth Quarter 1980



* Growth rates are seasonally adjusted compound annual rates.
Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System as revised in June 1980.

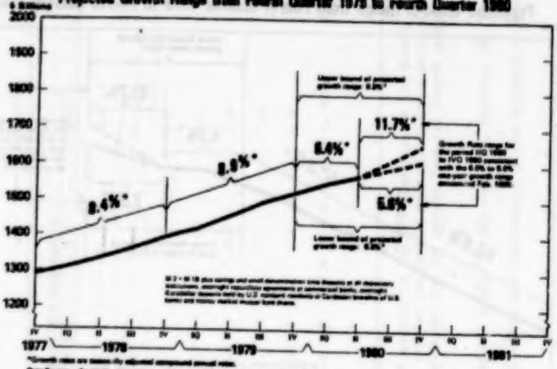
MONEY SUPPLY (M-1B)
Actual Levels from Fourth Quarter 1977 and Federal Reserve Projected Growth Range from Fourth Quarter 1979 to Fourth Quarter 1980



*Growth rates are seasonally adjusted compound annual rates.
Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System as revised in June 1980.

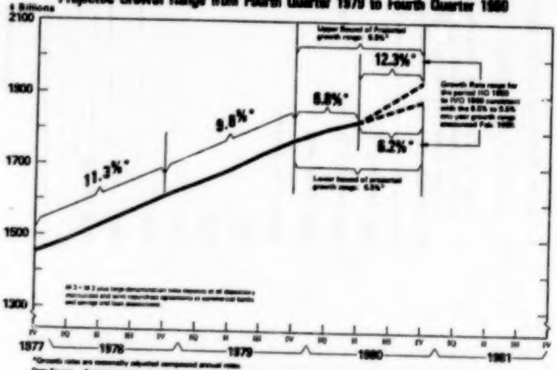
MONEY SUPPLY (M-2)

Actual Levels from Fourth Quarter 1977 and Federal Reserve
Projected Growth Range from Fourth Quarter 1979 to Fourth Quarter 1980

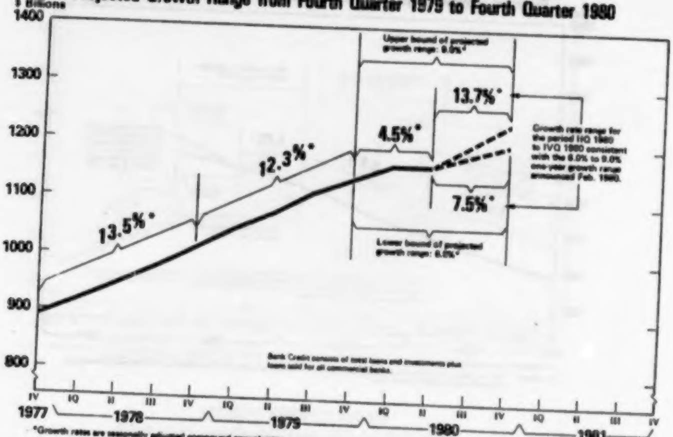


MONEY SUPPLY (M-3)

Actual Levels from Fourth Quarter 1977 and Federal Reserve
Projected Growth Range from Fourth Quarter 1979 to Fourth Quarter 1980



BANK CREDIT
Actual Levels from Fourth Quarter 1977 and Federal Reserve Projected Growth Range from Fourth Quarter 1979 to Fourth Quarter 1980



*Growth rates are seasonally adjusted compound annual rates.

Data Source: Quarterly observations and growth rates are calculated from seasonally adjusted data series of the Board of Governors of the Federal Reserve System.

GROWTH RATES FOR SELECTED MONETARY AND CREDIT AGGREGATES, 1975-1980 AND FEDERAL RESERVE ONE-YEAR TARGETS, 1980-1981

(Seasonally adjusted compound annual growth rates, percent)

time period 1/	Monetary aggregates				Bank credit
	M-1A	M-1B	M-2	M-3	
1975	4.7	4.9	12.3	9.4	4.1
1976	5.5	6.0	13.7	11.4	7.5
1977	7.7	8.1	11.5	12.6	11.1
1978	7.4	8.2	8.4	11.3	13.5
1979	5.0	7.6	8.9	9.8	12.3
1980-first quarter	4.9	6.1	7.4	8.0	9.8
1980-first half	0.4	1.8	6.4	6.8	4.5
1980-targets 2/	3.5 to 6.0	4.0 to 6.5	6.0 to 9.0	6.5 to 9.5	6.0 to 9.0
1981-targets 3/					

1/ Annual data are for periods from the fourth quarter of the previous year to the fourth quarter of the year indicated. First quarter data are for the period from the fourth quarter of 1979 to the first quarter of 1980. First half data are for the period from the fourth quarter of 1979 to the second quarter of 1980.

2/ Announced by the Federal Reserve in its Monetary Report to the Congress, February 19, 1980.

3/ To be announced by the Federal Reserve in its 1980 mid-year report to the Congress on monetary policy.

Sources: Calculated from data series of the Board of Governors of the Federal Reserve System, accessed July 1980 from data files of Data Resources, Inc.

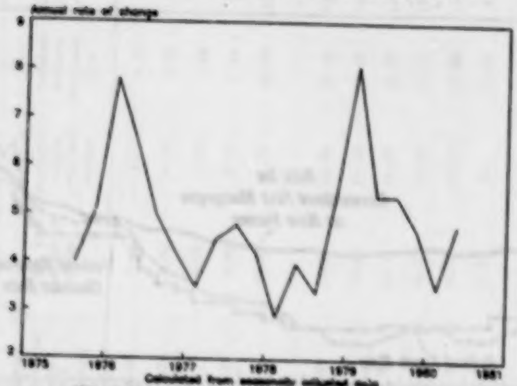
GROWTH RATES FOR SELECTED RESERVE AGGREGATES AND THE MONETARY BASE, 1975–1980
(seasonally adjusted compound annual growth rates, adjusted for changes in reserve requirements, percent)

time period[1/]	total reserves	required reserves	nonborrowed reserves	monetary base
1975	0.0	-0.2	3.2	5.8
1976	0.8	0.8	0.9	6.7
1977	5.1	5.2	2.9	8.2
1978	6.8	6.9	6.9	9.2
1979	2.9	2.7	0.9	7.6
1980–first quarter	4.5	5.5	3.6	7.7
1980–first half	3.3	3.8	6.0	6.6

[1/] Annual data are for periods from the fourth quarter of the previous year to the fourth quarter of the year indicated. First quarter data are for the period from the fourth quarter of 1979 to the first quarter of 1980. First half data are for the period from the fourth quarter of 1979 to the second quarter of 1980.

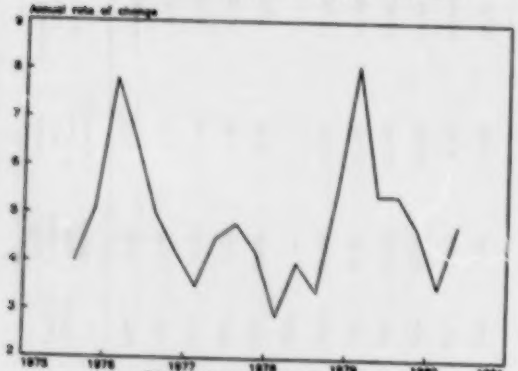
Sources: Calculated from data series of the Board of Governors of the Federal Reserve System, accessed July 1980 from data files of Data Resources, Inc.

INCOME VELOCITY OF MONEY (M–1A)
% CHANGE FROM SAME QUARTER, PREVIOUS YEAR



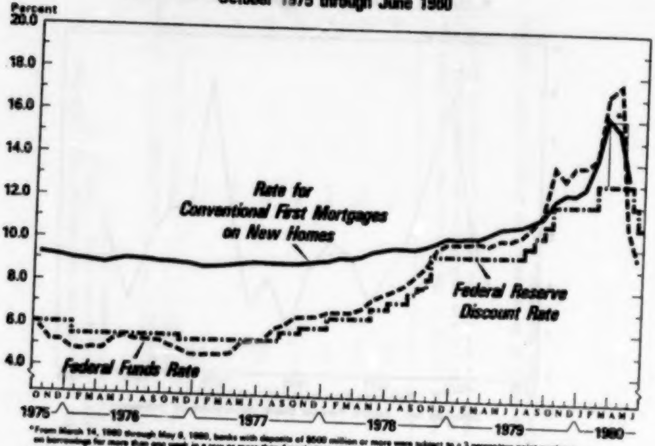
Calculated from seasonally adjusted data
Data sources: Federal Reserve Board; Department of Commerce

INCOME VELOCITY OF MONEY (M–1A)
% CHANGE FROM SAME QUARTER, PREVIOUS YEAR



Calculated from seasonally adjusted data
Data sources: Federal Reserve Board; Department of Commerce

SELECTED INTEREST RATES
October 1975 through June 1980



*From March 14, 1980 through May 6, 1980, banks with deposits of $500 million or more were subject to a 3 percentage point surcharge on borrowings for more than one week in a row or more than 4 weeks in a calendar quarter.

Data Sources: Board of Governors of the Federal Reserve System and Federal Housing Administration Department of Housing and Urban Development.

SELECTED INTEREST RATES, 1975-1980
(average, percent per annum)

Year or Month	Treasury bills, 3 month, new issues	Treasury bonds, over 10 years, composite	Corporate Aaa bonds, Moody's	Prime commercial paper, 3 months	Prime rate charged by banks	New home mortgage yields, FHA/HUD series	Federal Reserve Discount rate	Federal funds rate
1975	5.84	7.00	8.83	6.25	7.86	9.10	6.25	5.82
1976	4.99	6.79	8.43	5.24	6.84	9.00	5.50	5.05
1977	5.26	7.06	8.02	5.55	6.82	9.00	5.46	5.54
1978	7.22	7.89	8.73	7.94	9.06	9.70	7.46	7.94
1979	10.04	8.74	9.63	10.97	12.67	11.14	10.28	11.20
1980:								
Jan.	12.04	10.03	11.09	13.04	15.25	12.80	12.00	13.82
Feb.	12.81	11.55	12.38	13.78	15.63	14.10	12.50	14.13
Mar.	15.53	11.87	12.96	16.81	18.31	16.05	13.00	17.19
Apr.	14.00	10.83	12.04	15.78	19.77	15.55	13.00	17.61
May	9.15	9.82	10.99	9.49	16.57	13.20	12.90	10.98
June	7.00	9.40	10.58	8.27	12.63	NA	11.43	9.47

Sources: Board of Governors of the Federal Reserve System, Department of Housing and Urban Development, and Moody's Investors Service.

FUNDS RAISED IN U.S. CREDIT MARKETS

[In billions of dollars; quarterly data are seasonally adjusted at annual rates]

	1975	1976	1977	1978	1979	1979 (II)	1979 (III)	1979 (IV)	1980 (I)
Total funds raised, by instrument:	223.5	296.0	392.5	481.7	481.4	486.8	557.0	429.1	516.6
Investment company shares	-.1	-1.0	-.9	-1.0	-2.1	-.6	-2.7	-5.1	-1.0
Other corporate equities	10.8	12.9	4.9	4.7	7.3	5.8	8.3	9.5	13.5
Debt instruments:	212.8	284.1	388.5	478.0	476.2	481.6	551.4	424.7	504.1
U.S. Government securities	98.2	88.1	84.3	95.2	89.9	74.3	95.3	117.4	116.6
State and local obligations	16.1	15.7	23.7	28.3	21.4	12.5	25.3	25.3	21.1
Corporate and foreign bonds	36.4	37.2	36.1	31.6	32.2	35.8	35.4	22.8	25.4
Mortgages	57.2	87.1	134.0	149.0	158.1	164.5	161.0	148.6	140.7
Consumer credit	9.7	25.6	40.6	50.6	42.3	44.2	45.1	29.3	26.0
Bank loans, n.e.c.	-12.2	7.0	29.8	58.4	52.5	64.0	96.2	16.5	78.3
Open market paper	-1.2	8.1	15.0	26.4	40.5	44.9	55.3	24.1	50.6
Other loans	8.7	15.3	25.2	38.6	39.5	41.4	37.7	40.7	45.4

Source: Board of Governors of the Federal Reserve System. 1980(I) based on incomplete data.

FEDERAL BUDGET RECEIPTS AND OUTLAYS
(in billions of dollars) 1/

Fiscal year or period	Budget receipts	Budget outlays	Budget surplus or deficit
1975	281.0	326.2	-45.2
1976	300.0	366.4	-66.4
Transition quarter	81.8	94.7	-13.0
1977	357.8	402.7	-45.0
1978	402.0	450.8	-48.8
1979	465.9	493.7	-27.7
1980 (estimates):			
Budget Revisions, March 1980 2/	532.4	568.9	-36.5
Third Concurrent Resolution, June 12, 1980	525.7	572.7	-47.0
1981 (estimates):			
Budget Revisions, March 1980 2/	628.0	611.5	16.5
First Concurrent Resolution, June 12, 1980	613.8	613.6	.2
Cumulative total, first 8 months:			
Fiscal year 1979	292.1	328.2	-36.0
Fiscal year 1980	325.8	381.9	-56.0

1/ Unified budget basis.

2/ Estimates from Office of Management and Budget, Fiscal Year 1981 Budget Revisions, March 1980.

Source: Economic Indicators, June 1980.

BUDGET RECEIPTS AND OUTLAYS AS A PERCENT OF GNP, 1958-1983

Fiscal year	Gross national product ($ billions)	Budget receipts as percent of GNP	Budget outlays as percent of GNP
1958	442.1	18.0	18.7
1959	473.3	16.7	19.5
1960	497.3	18.6	18.5
1961	508.3	18.6	19.2
1962	546.9	18.2	19.5
1963	576.3	18.5	19.3
1964	616.2	18.3	19.2
1965	657.1	17.8	18.0
1965	721.1	18.1	18.7
1967	774.4	19.3	20.4
1968	829.9	18.5	21.5
1969	903.7	20.8	20.4
1970	959.0	20.2	20.5
1971	1,019.3	18.5	20.7
1972	1,110.5	18.8	20.9
1973	1,237.5	18.8	20.0
1974	1,359.2	19.5	19.8
1975	1,457.3	19.3	22.4
1976	1,621.0	18.5	22.6
(1/)			
1977	1,843.3	19.4	21.8
1978	2,060.4	19.5	21.9
1979	2,313.4	20.1	21.3
Budget, 1980:			
1980 estimate	2,518.0	20.8	22.4
1981 estimate	2,764.4	21.7	22.3
1982 estimate	3,107.6	22.2	22.1
1983 estimate	3,513.0	22.7	22.0
Budget revisions, March 1980:			
1980 estimate	2,554.6	20.8	22.3
1981 estimate	2,796.7	22.5	21.9
1982 estimate	3,151.0	23.0	21.7
1983 estimate	3,570.7	23.5	21.3

1/ Transition quarter omitted.

Source: Office of Management and Budget, Federal Government Finances, January and April 1980 editions.

1980 AND 1981 ECONOMIC FORECASTS OF CHASE ECONOMETRICS ASSOCIATES, INC. AND DATA RESOURCES INC., RELEASED JUNE 1980

Item	1980		1981	
	Chase 1/	DRI 2/	Chase 1/	DRI 2/
	Level, fourth quarter 3/			
Employment (millions)	96.2	96.0	97.8	98.3
Unemployment (percent)	8.7	8.8	8.5	8.4
	Percent change, fourth quarter to fourth quarter			
Nominal gross national product	5.0	4.6	12.3	13.8
Real gross national product	-3.5	-4.0	3.1	4.4
Real disposable income	-2.2	-1.6	1.7	2.7
Productivity 4/				
total economy	—	—	—	—
private business	-1.0	—	1.3	—
private nonfarm	-2.9	-2.5	1.0	1.4
Consumer price index	12.9	11.5	9.7	9.1
GNP implicit price deflator	8.9	8.9	9.0	9.0

1/ The Chase forecast assumes that Federal personal income taxes will be cut by $16 billion beginning on October 1, 1980 and that corporate taxes will be reduced by $9 billion effective January 1, 1981. It is also assumed that there will be an easing in Federal Reserve policy. Chase expects some further increases in OPEC prices, but these advances are assumed to be much more modest than the hikes imposed over the past year.

2/ The DRI forecast assumes a $30 billion Federal tax cut will become effective January 1, 1981. This tax reduction provides $18 billion in personal tax relief and a $12 billion cut in corporate tax liabilities. Monetary policy is expected to become more accommodative, although it is assumed that the Federal Reserve will adhere to the monetary growth targets established in February 1980. The forecast also assumes a modest increase in the price of oil. OPEC is expected to raise its prices by 15 percent between the fourth quarter 1980 and the fourth quarter 1982.

3/ Seasonally adjusted.

4/ Based on total real GNP per hour worked.

Sources: Chase Econometrics Associates, Inc. Standard Forecast of June 20, 1980.
Data Resources, Inc. Central Forecast of June 22, 1980.

1980 ECONOMIC PROJECTIONS OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, RELEASED FEBRUARY 1980

Item	Year	
	Actual	Projected
	1979	1980
	Level, fourth quarter	
Employment (millions)	97.7	97 to 98 3/4
Unemployment rate (percent)	5.9	6 3/4 to 8
	Percent change, fourth quarter to fourth quarter	
Nominal gross national product	9.9	7 1/2 to 11
Real gross national product	0.8	-2 1/2 to 1/2
Implicit price deflator	9.0	9 to 11
	Annual rate of change in fourth quarter, percent	
Consumer price index	13.2	8 3/4 to 12

Source: Board of Governors of the Federal Reserve System, Monetary Policy Report to Congress, February 19, 1980, p. 7.

1980 AND 1981 ECONOMIC FORECASTS OF THE ADMINISTRATION, RELEASED JANUARY 1980 AND REVISED MARCH 1980

Item	1980	1981 1/
	Level, fourth quarter	
Employment (millions)		
January 1980	97.8	99.7
March 1980 revisions	—	—
Unemployment rate (percent)		
January 1980	7.5	7.3
March 1980 revisions	7.2	7.3
	Percent change, fourth quarter to fourth quarter	
Nominal gross national product		
January 1980	7.9	11.7
March 1980 revisions	10.0	11.4
Real gross national product		
January 1980	-1.0	2.8
March 1980 revisions	-0.4	2.2
Real disposable income		
January 1980	.5	1.1
March 1980 revisions	—	—
Productivity--total economy 2/		
January 1980	-.3	1.3
March 1980 revisions	—	—
Consumer price index		
January 1980	10.7	8.7
March 1980 revisions	12.8	9.0
GNP implicit price deflator		
January 1980	9.0	8.6
March 1980 revisions	10.4	9.1

1/ Seasonally adjusted.

2/ Based on total real GNP per hour worked.

Sources: U.S. Council of Economic Advisers. Economic Report of the President. Washington. U.S. Govt. Print. Off., 1980.
Office of Management and Budget. Fiscal Year 1981 Budget Revisions, March 1980.

SUMMARY OF ADMINISTRATION'S ECONOMIC GOALS CONSISTENT WITH THE OBJECTIVES OF THE HUMPHREY-HAWKINS ACT, RELEASED JANUARY 1980 1/

Item	YEAR					
	Goal Forecasts		Goal Requirements			
	1980	1981	1982	1983	1984	1985
	Level, fourth quarter 2/					
Employment (millions)	97.8	99.7	102.5	105.3	108.0	110.7
Unemployment (percent)	7.5	7.3	6.5	5.6	4.8	4.0
	Percent change, fourth quarter to fourth quarter					
Real gross national product	-1.0	2.8	5.0	5.0	4.8	4.6
Real disposable income	.5	1.1	4.7	4.7	4.6	4.4
Productivity 3/	-.3	1.3	2.3	2.5	2.5	2.5
Consumer prices	10.7	8.7	7.9	7.2	6.5	5.8

1/ Among the provisions of the Humphrey-Hawkins Act are those setting an unemployment goal of 4% among individuals aged 16 and over in the civilian labor force by 1983 and an inflation rate of 3% as measured by the consumer price index, also by 1983. The Act requires that beginning in the 1980 Economic Report the President review the numerical goals and timetables for reducing unemployment and inflation and report to the Congress on the degree of progress being made in these areas. From this time, if the President finds it necessary, he may recommend modification of the timetable(s) for achieving the unemployment and inflation goals.

According to the 1980 Economic Report:

> ...the President has used the authority provided to him in the Humphrey-Hawkins Act to extend the timetable for achieving a 4 percent unemployment rate and 3 percent inflation. The target year for achieving 4 percent unemployment is now 1985, a 2-year deferment. The target year for achieving 3 percent inflation has been postponed until 3 years beyond that. Economic goals through 1985 consistent with this timetable are shown [in the table above].
>
> The short-term goals represent a forecast for 1980 and 1981. The medium-term goals for 1982 through 1985 are not forecasts but projections of the economic performance needed to achieve the unemployment rate and inflation goals within the Administration's timetable...
>
> (p. 94)

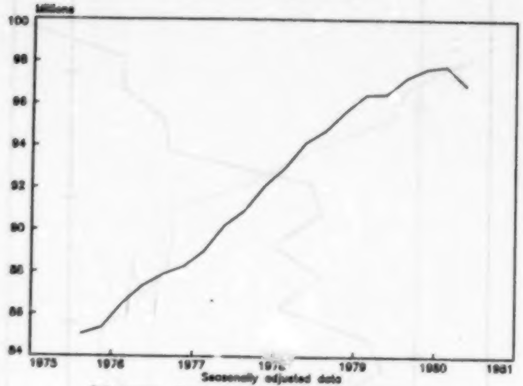
In March 1980 some revised forecasts and projections were included in the Office of Management and Budget Fiscal Year 1981 Budget Revisions; these revisions have not been incorporated in the table above.

2/ Seasonally adjusted.

3/ Based on total real GNP per hour worked.

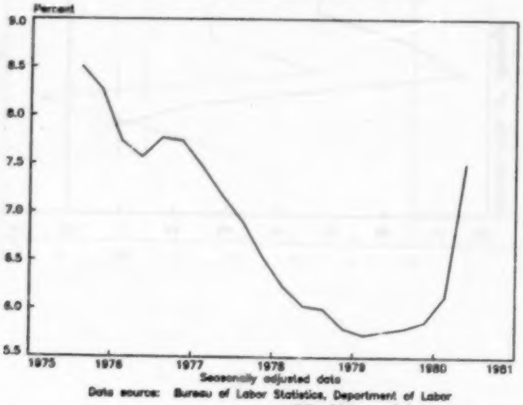
Source: U.S. Council of Economic Advisers. Economic Report of the President. Washington, U.S. Govt. Print. Off., 1980.

EMPLOYMENT
TOTAL CIVILIAN EMPLOYMENT



Data source: Bureau of Labor Statistics, Department of Labor

UNEMPLOYMENT
PERCENT OF CIVILIAN LABOR FORCE



Data source: Bureau of Labor Statistics, Department of Labor

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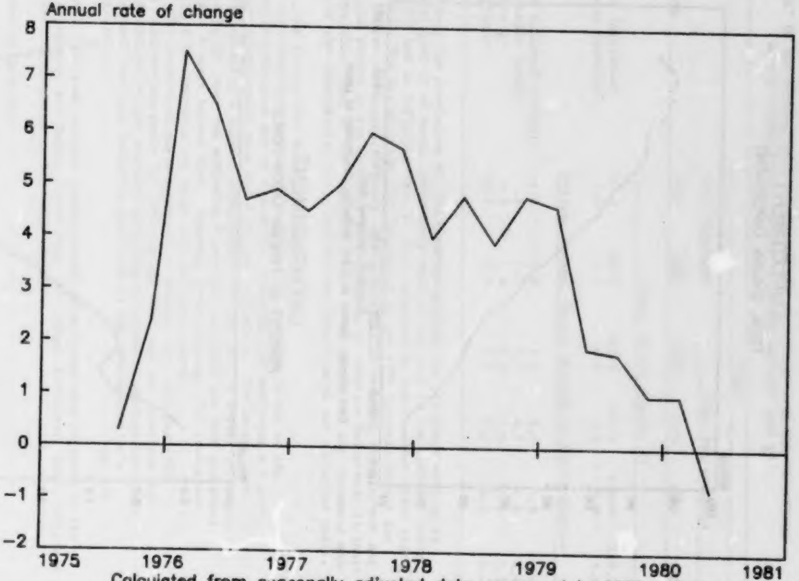
PRODUCTION: REAL GNP

% CHANGE FROM SAME QUARTER, PREVIOUS YEAR



Calculated from seasonally adjusted data expressed in 1972 dollars

Data source: Bureau of Economic Analysis, Department of Commerce

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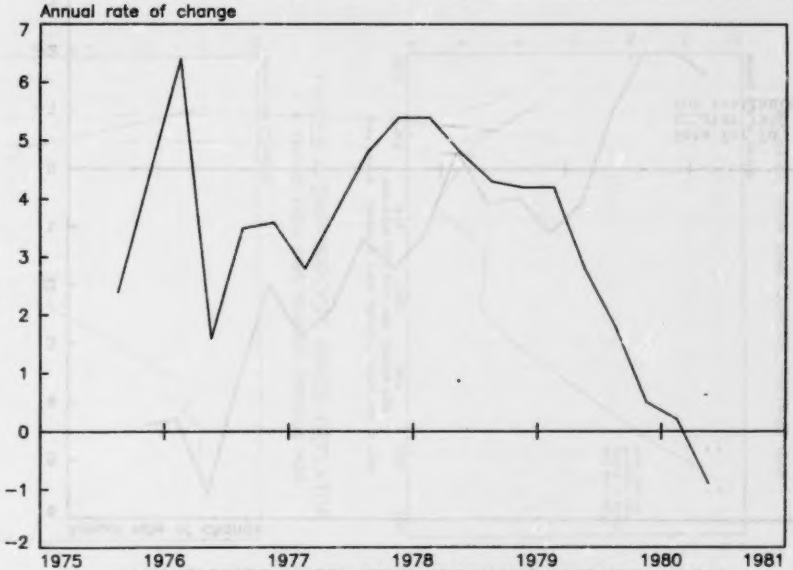
REAL INCOME: DISPOSABLE PERSONAL INCOME

% CHANGE FROM SAME QUARTER, PREVIOUS YEAR

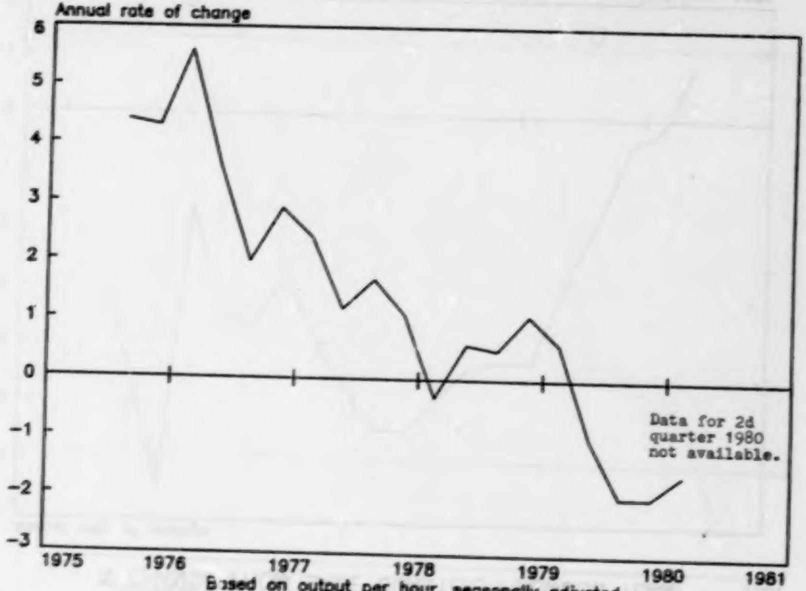


Calculated from seasonally adjusted data expressed in 1972 dollars

Data source: Bureau of Economic Analysis, Department of Commerce

PRODUCTIVITY: NONFARM BUSINESS SECTOR

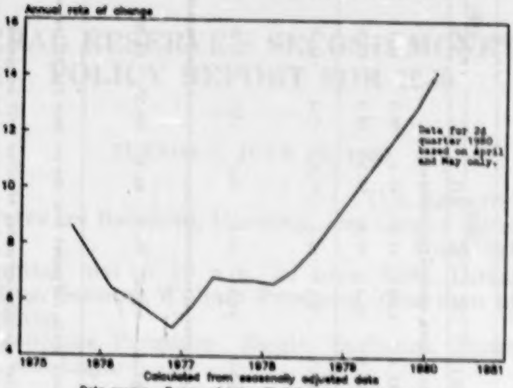
% CHANGE FROM SAME QUARTER, PREVIOUS YEAR



Based on output per hour, seasonally adjusted

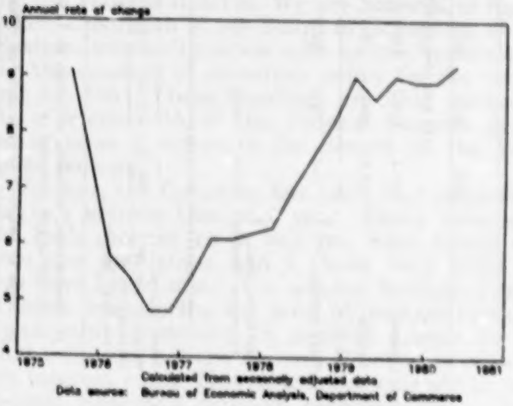
Data source: Bureau of Labor Statistics, Department of Labor

PRICES: CONSUMER PRICE INDEX
% CHANGE FROM SAME QUARTER, PREVIOUS YEAR



Data source: Bureau of Labor Statistics, Department of Labor

PRICES: GNP IMPLICIT PRICE DEFLATOR
% CHANGE FROM SAME QUARTER, PREVIOUS YEAR



Data source: Bureau of Economic Analysis, Department of Commerce

EXPORTS, IMPORTS, TRADE BALANCE 1/ AND TRADE-WEIGHTED EXCHANGE VALUE OF THE U.S. DOLLAR 2/

	1975	1976	1977	1978	1979	1979				1980	
						I	II	III	IV	I p	II
	(in billions of dollars; quarterly data seasonally adjusted)										
Exports	107.1	114.7	120.8	142.1	182.1	41.8	42.8	47.2	50.2	54.7	
Imports	98.0	124.0	151.7	175.8	211.5	46.9	50.9	54.3	59.5	65.6	
Trade balance	9.0	-9.4	-30.9	-33.8	-29.5	-5.1	-8.1	-7.1	-9.2	-10.9	
Memorandum item: Petroleum imports	27.0	34.6	45.0	42.3	60.0	11.6	13.5	16.1	18.9	21.6	
Index of the weighted-average exchange value of the U.S. dollar	98.34	105.57	103.30	92.39	88.09	88.14	89.79	86.97	87.37	87.38	87.78

1/ Merchandise, excluding military, on balance of payments basis (adjusted from Census data for differences in timing and coverage).

2/ Index of weighted average exchange value of U.S. dollar against currencies of other G-10 countries (Germany, Japan, France, United Kingdom, Canada, Italy, Netherlands, Belgium, Sweden) and Switzerland. March 1973=100. Weights are 1972-1976 global trade of each of the 10 countries.

Sources: Exports, imports, and trade balance - Department of Commerce, Bureau of Economic Analysis. Trade-weighted exchange value of the U.S. Dollar - Board of Governors of the Federal Reserve System.

FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1980

TUESDAY, JULY 22, 1980

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 10 a.m., in room 5302, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Sarbanes, Stewart, Garn, Kassebaum, and Lugar.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

This morning we continue our hearings on the conduct of monetary policy by the Federal Reserve. We are honored to have with us Paul A. Volcker, Chairman of the Board of Governors of the Federal Reserve System, who will discuss with us the System's objectives and plans for the conduct of monetary policy for the remainder of this year and for 1981. These hearings are held pursuant to the requirements of section 2A of the Federal Reserve Act and the committee must issue a report to the Senate on the Federal Reserve's intended policies.

Chairman Volcker, the Congress has been very supportive of the Federal Reserve's actions this past year. There were some complaints about high interest rates but you have heard very little criticism from the politicians and I think very little from the Congress. You have heard some. You always do when interest rates go up, but I think, considering the level of interest rates, criticism has been remarkably moderate. In general there's an increased awareness that inflation, not the Federal Reserve, is responsible for the very high interest rates. This awareness extends to recognition that the Federal Reserve's primary responsibility is to manage money and credit availability, and to do it in a manner that will lead to price stability.

I hope that the Congress will continue to support the Fed's efforts to reduce inflation. In order to signal to the Federal Reserve that you have that support I have introduced a concurrent resolution on monetary policy, and I hope it will receive wide, bipartisan support in the Congress. The resolution has been supported by the "Committee To Fight Inflation," which as you know, Mr. Chairman, is a bipartisan group composed of seven Democrats and six Republicans with lengthy experience in economic policymaking.

So that we have that resolution clearly in mind as we hear your report, I would like to read a portion of it now.

It says:

> That it is the sense of the Congress that the Board of Governors and the Federal Open Market Committee:
>
> One. Adhere to a long-run anti-inflation policy until significant progress has been made in reducing inflation and establishing a financial framework conducive to a non-inflationary economy.

I might just point out that yesterday we had three distinguished economists who agreed wholeheartedly with that. They disagreed on other issues, but they agreed with the resolution and they also agreed to the notion that the Federal Reserve should proceed with a steady course to reduce the rate of increase in the supply of money. I noticed that Lindley Clark in the Wall Street Journal this morning had a very thoughtful column along the same line.

The resolution goes on to say:

> Two. Pursue policies over the remainder of 1980 and 1981 so as to encourage reductions in the rate of inflation and expansion in the rates of growth of the monetary and credit aggregates appropriate to facilitating economic growth; and
>
> Three. Work toward establishing long-run rates of growth of money and credit consistent with the economy's long-run potential to expand output and productivity in order to promote full employment, balanced growth, and price stability, by gradually reducing the rates of growth of the monetary and credit aggregates in a firm and stable manner.

I might add that Senator Garn is a cosponsor of the resolution and that former Fed Chairmen William McChesney Martin and Arthur F. Burns have written me to indicate that they are in support of it also. I hope that the Federal Reserve is not only in support of the resolution, but that the Federal Open Market Committee will put in place the type of policies and the long-run commitments that the resolution seeks to encourage.

Chairman Volcker, as always, the Federal Reserve is in the hotseat. This morning's newspapers tell us the Federal deficit is now projected to reach $60 billion this year and $30 billion next year without a tax cut and much more with a tax cut, so that fiscal policy may not be supportive of your anti-inflation efforts. Inflation is intolerably high, and most labor costs are not likely to decline during this recession, as a result our inflationary base is likely to be quite high as we come out of the recession. Failure to adhere to an explicit, visible commitment to monetary policies to reduce inflation in a steady manner could seriously jeopardize the future well-being of the Nation, as well as the credibility of the Federal Reserve System.

We would be delighted to have you go ahead and I have some questions and I'm sure Senator Garn will be along a little later.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. I have a statement which I hope puts things in a little perspective. We have had a turbulent period, Mr. Chairman, and with your permission, I will read my statement.

The CHAIRMAN. Fine.

Mr. VOLCKER. I am pleased to be here today to review the conduct of monetary policy and to report on the Federal Reserve's economic objectives for the year as a whole, as well as its tentative thinking on policy goals for 1981. Our so-called Humphrey-Hawkins report has already been distributed to you. I would like simply to add some personal perspective this morning on the course of monetary policy, in the context of the economic prospects and choices facing us with respect to other policy instruments.

Seldom has the direction of economic activity changed so swiftly as in recent months. Today the country is faced simultaneously with acute problems of recession and inflation. There have been unprecedented changes in interest rates and the imposition and removal of extraordinary measures of credit restraint. The fiscal position of the Federal Government is changing rapidly.

In these circumstances, confusion and uncertainty can arise about our goals and policies, not just those of the Federal Reserve, but of economic policy generally. Therefore, I particularly welcome this opportunity to emphasize the underlying continuity in our approach in the Federal Reserve and its relationship to other economic policies, matters that are critical to public understanding, and expectations.

FINANCIAL DISCIPLINE

The Federal Reserve has been, and will continue to be, guided by the need to maintain financial discipline—a discipline concretely reflected in reduced growth over time of the monetary and credit aggregates—as part of the process of restoring price stability. As I see it, this continuing effort reflects not simply a concern about the need for greater monetary and price stability for its own sake—critical as that is. The experience of the 1970's strongly suggests that the inflationary process undercuts efforts to achieve and maintain other goals, expressed in the Humphrey-Hawkins Act, of growth and employment.

As you know, our operating techniques since last October have placed more emphasis on maintaining reserve growth consistent with targeted ranges for the various M's, with the implication interest rates might move over a wider range. Those targets were reduced this year as one step toward achieving monetary growth consistent with greater price stability. For several months after the new techniques were introduced in October, the various aggregates were remarkably close to the targeted ranges.

At that time, and for months earlier, you will recall widespread anticipations of recession. Nevertheless, reflecting a variety of developments at home and abroad—including an enormous new increase in oil prices, Middle-Eastern political volatility, and interpretations of adverse budgetary developments—there was a marked surge in the most widely disseminated price indices and in inflationary expectations in the early part of this year. Those expectations in the short run probably helped to support business activity for a time; in particular, consumer spending relative to income remained very high, with the consequence of historically—and fundamentally unhealty—low savings rates and high debt ratios. Speculation was rife in commodity markets.

Spending and speculative activities of that kind are ultimately unsustainable. But they carried the clear threat of feeding upon themselves for a time, contributing among other things to a further acceleration of wage rates and prices. In that way, inflation threatened to escalate still further in a kind of self-fulfilling prophecy, posing the clear risk that the subsequent economic adjustment would be still more difficult.

Credit markets reflected these developments and attitudes. Bond prices fell precipitously. Long-term money—including mortgages—became difficult to raise. Partly as a consequence, short-term demands for credit ballooned in the face of sharply rising interest rates, at the expense in some instances of further weakening business balance sheets. That heavy borrowing also was reflected in acceleration in the money and credit aggregates during the winter.

An attempt to stabilize interest rates by the provision of large amounts of bank reserves through open market operations to support even more rapid growth in money would probably have been doomed to futility even in the short run, for it could only have fed the expectations of more inflation. It would certainly have been counterproductive in terms of the overriding long-term need to combat inflation and inflationary anticipations. Instead, consistent with our basic policy approaches and techniques, the Federal Reserve resisted accommodating the excessive money and credit growth.

During this period of rising inflation and interest rates, the administration and the Congress also appropriately and intensively reviewed their own budget planning. Coordinated with the announcement of the results of that broad governmental effort and the decision of the President to invoke the Credit Control Act of 1969, the Federal Reserve announced on March 14 a series of exceptional, temporary measures to restrain credit growth, reinforcing and supplementing our more traditional and basic instruments of policy.

The demand for money and credit dropped abruptly in subsequent weeks, reflecting the combined cumulative effects of the tightening of market conditions, the announcement of the new actions, and the rather sudden weakening of economic activity. In response, interest rates within a few weeks fell about as fast—in some instances faster and further—than they had risen in earlier months. Growth in the aggregates slowed, and for some weeks M1-A and M1-B turned sharply negative.

There is no doubt in my mind that these lower levels of interest rates can play a constructive role in the process of restoring a better economic equilibrium and fostering recovery. Indeed, there is already evidence—if still tentative—that homebuilding and other sectors of the economy sensitive to credit costs and availability are benefiting. Meanwhile, progress is being made toward reducing consumer indebtedness relative to income and toward restructuring corporate balance sheets as bond financing has resumed at a very high level. The sharp improvement in credit market conditions has been accompanied by slower rates of increase in consumer and producer prices, helping to quiet earlier fears of many of an explosive increase in inflation.

CHANGE IN MARKET CONDITIONS

The suddenness of the change in market conditions has, however, raised questions in some minds as to whether the interest rate declines were in some manner contrived or forced by the Federal Reserve—whether, to put it bluntly, the performance of the markets—together with the phased removal of the special credit restraints—reflects some weakening of our basic commitment to disciplined monetary policy and the priority of the fight on inflation. These perceptions are not irrelevant, for they could affect both expectations and behavior, most immediately in the financial and foreign exchange markets, but also among businessmen and consumers.

The facts seem to me quite otherwise.

Growth in money and credit since March has certainly not exceeded our targets; the M-1 measures have in fact been running below our target ranges. Bank credit has declined in recent months; while the decline in commercial loans of banks can be explained in part by exceptionally heavy bond and commercial paper issuance by corporations, there is simply no evidence of excessive rates of credit expansion currently. In these circumstances, it is apparent that interest rates have responded—and have been permitted to respond—not to any profligate and potentially inflationary increase in the supply of money, but to changes in credit demands, and—so far as long-term interest rates are concerned—to reduced inflationary expectations.

It is in that context—with credit demands reduced and growth of credit running well within our expectations and targets—that the special credit restraint programs simply served no further purpose. Those measures were invoked to achieve greater assurance that credit growth would in fact slow, and that appropriate caution would be observed in credit usage. The special restraints are inevitably cumbersome and arbitrary in specific application. They involve the kind of arbitrary intrusion into private decisionmaking and competitive markets that should not be part of the continuing armory of monetary policy; their use was justified only by highly exceptional circumstances—circumstances that no longer exist. Our normal and traditional tools of control—which in fact have been solidified by the Monetary Control Act passed earlier this year—are intact and fully adequate to deal with foreseeable needs.

Neither the decline in interest rates nor the removal of the special restraints should be interpreted as a invitation to consumers or businessmen to undertake incautious or imprudent borrowing commitments, or as lack of concern should excessive growth in money or credit reappear. That is not happening now. But markets—and the public at large—remain understandably extremely sensitive to developments that might aggravate inflationary forces. As we saw only a few months ago, consumers and businessmen will react quickly in their lending and borrowing behavior to that threat.

While the recent easing of financial pressures helps provide an environment conducive to growth, we should not be misled. A resurgence of inflationary pressures, or policies that would seem to lead to that result, would not be consistent with maintenance of present—much less lower—interest rates, receptive bond markets, and improving mortgage availability. We in the Federal Reserve believe the kind of commitment we have made to reduce monetary growth over time is a key element in providing assurance that the inflationary process will be wound down.

I noted earlier the money stock actually dropped sharply during the early spring. In a technical sense, working on the supply side, we provided substantial reserves through open market operations during that period, but commercial banks, finding demands for credit and interest rates dropping rapidly, repaid discount window borrowings as their reserve needs diminished. In general terms, it seems clear that, at least for a time, the demand for money subsided—much more than can be explained on the basis of established relationships to business activity and interest rates—apparently because consumers and others hastened debt repayment at the expense of cash balances and because the earlier interest rate peaks had induced individuals to draw on cash to place the funds in investment outlets available in the market.

As the report illustrates, M-1 growth has clearly resumed, and the broader aggregate M-2 is now at or above the midpoint of its range. In the judgment of the Federal Open Market Committee, forcing reserves on to the market in recent weeks simply to achieve the fastest possible return to, say, the midpoint of the M-1 ranges may well have required early reversal of that approach, have been inconsistent with the close-to-target performance of the broader aggregates, and therefore led to unwarranted interpretations and confusion about our continuing objectives. Depending on the performance of the broader aggregates and our continuing analysis of general economic developments, the FOMC is in fact prepared to contemplate that M-1 measures may fall significantly short of the midpoint of their specified ranges for the year.

I have emphasized the committee's intention to work toward the lower levels of monetary expansion over time. In reviewing the situation this month, the committee felt that, on balance, it would be unwise to translate that intention into specific numerical targets for 1981 for the various M's at this time. That view was strongly reinforced by certain important technical uncertainties related to the introduction of NOW accounts nationwide next January, as well as by the need to assess whether the apparent shift in demand for cash in the spring persists.

At the same time, the general nature of the potential problem and dilemmas for 1981 and beyond is clear enough; these are important questions, not just for monetary policy but for the full armory of public policy.

The targets for the monetary aggregates are designed to be consistent with, and to encourage, progress toward price stability without stifling sustainable growth. But in the short run, the demand for money—at any given level of interest rates—tends to be related not to prices or real output alone, but to the combined effects of both—the nominal GNP. If recovery and expansion are accompanied by inflation at current rates or higher, pressures on interest rates could develop to the point that consistency of strong economic expansion with reduced monetary growth would be questionable.

Obviously, a satisfactory answer cannot lie in the direction of indefinitely continued high levels of unemployment and poor economic performance. But ratifying strong price pressures by increases in the money supply offer no solution; that approach could only prolong and intensify the inflationary process—and in the end undermine the expansion. The insidious pattern of rising rates of inflation and unemployment in succeeding cycles needs to be broken; with today's markets so much more sensitized to the dangers of inflation, economic performance would likely be still less satisfactory if that pattern emerges again. The only satisfactory approach must lie in a different direction—a credible effort to reduce inflation further in the period ahead, and policies that hold out the clear prospect of further gains over time, even as recovery takes hold.

INFLATION RATE DROPS

We are now in the process of seeing the inflation rate, as recorded in the consumer and producer price indexes, drop to or even below what can be thought of as the underlying or core rate of inflation of 9 to 10 percent. That core rate is roughly determined by trends in wages and productivity. We can take some satisfaction in the observed drop of inflation, and the damping of inflationary expectations. But the hardest part of this job lies ahead, for we now need to make progress in improving productivity or reducing underlying cost and wage trends—as a practical matter both—to sustain the progress.

The larger the productivity gain, the smoother will be the road to price stability—partly because that is the only way of achieving and sustaining growth in real incomes needed to satisfy the aspirations of workers. Put in that light, the importance of a concerted set of policies to reconcile our goals—not simply relying on monetary policy alone—is apparent. While those other policies clearly extend beyond the purview of the Federal Reserve, they obviously will bear upon the performance of financial markets and the economy as the Federal Reserve moves toward reducing over time the rate of growth in money and credit.

In that connection, I recognize the strong conceptual case that can be made for action to reduce taxes. Federal taxes already account for an historically large proportion of income. With inflation steadily pushing income taxpayers into higher brackets and with another large payroll tax increase to finance social security scheduled for 1981, the ratio will go higher still. The thesis that this overall tax burden—and the way our tax structure impinges on savings and investment, cost, and incentives—damages growth and productivity seems to me valid. Moreover, depending on levels of spending and the business outlook next year, the point can be made that the implicit and explicit tax increases in store for next year will drain too much purchasing power from the economy, unduly affecting prospects for recovery.

But I must also emphasize there are potentially adverse consequences that cannot be escaped—to ignore them would be to jeopardize any benefits from tax reduction, and risk further damage to the economy.

Whatever the favorable effects of tax reduction on incentives for production and productivity over time, the more immediate consequences for the size of the Federal deficit, and potentially for interest rates and for sectors of the economy sensitively dependent on credit markets, need to be considered.

Many of the most beneficial effects of a tax reduction depend upon a conviction that it will have some permanence, which in turn raises questions of an adequate commitment to complementary spending policies and appropriate timing. We are not dealing with a notion of a quick fix over the next few months for a recession of uncertain duration, but of tax action for 1981 and beyond at a time when Federal spending levels, even for fiscal 1981, appear to be a matter of considerable uncertainty, with the direction of movement higher.

Experience is replete with examples of stimulation, undertaken with the best motives in the world, that has turned out in retrospect to have been ill-timed and excessive. Given the demonstrable frailty of our economic forecasting, it takes a brave man indeed to project with confidence the precise nature of the budgetary and economic situation that will face the Nation around the end of this year. Moreover, an intelligent decision on the revenue side of the budget implies knowledge of the spending priorities of an administration and a Congress, a matter that by the nature of things can only be fully clarified after the election.

For all the developing consensus on the need for supply side tax reduction—and I share in that consensus—some time seems to me necessary to explore the implications of the competing proposals and to reduce them to an explicit detailed program for action. I have emphasized the need to achieve not only productivity improvement but also a lower trend of costs and wages; despite its importance, I have seen relatively little discussion in the current context of how tax reduction plans might be brought to bear more directly on the question of wage and price increases.

The continuing sensitivity of financial markets, domestic and international, to inflationary fears is a fact of life. It adds point and force to these observations and questions. Tax and budgetary programs leading to the anticipation of excessive deficits and more inflation can be virtually as damaging as the reality in driving interest rates higher at home and the dollar lower abroad.

I believe it is obvious from these remarks that a convincing case for tax reduction can be made only when crucial questions are resolved—questions that are not resolved today. The appropriate time for decision seems to me late this year or early 1981. Fiscal 1982 as well as fiscal 1981 spending plans can be clarified. We will know if recovery of business is firmly underway. There will have been time to develop and debate the most effective way of maximizing the cost-cutting and incentive efforts of tax reduction, and to see whether a tax program can contribute to a consensus—a consensus that has been elusive in the past—on wage and pricing policies consistent with progress toward price stability. To go ahead prematurely would surely risk dissipating the potential benefits of tax reduction amid the fears and actuality of releasing fresh inflationary forces.

I have spoken before with this committee and others about the need for changes in other areas of economic policy to support our economic goals. Paramount is the need to reduce our dependence on foreign oil—a matter not unrelated to tax policy. We need to attack those elements in the burgeoning regulatory structure that impede competition or add unnecessarily to costs. And I believe it would be a serious mistake to seek relief from our present problems by retreat to protectionism, at the plain risk of weakening the forces of competition, the pressures on American industry to innovate, and undermining the attack on inflation.

We are now at the critical point in our efforts to reduce inflation while putting the economy back on the path to sustainable growth in the 1980's.

I sense the essential objectives are widely understood and agreed—the need to wind down inflation even as recovery proceeds; the importance of restoring productivity and increasing incentives for production and investment; the maintenance of open, competitive markets; a substantial reduction in our dependence on foreign energy.

You know as well as I how much remains to be done to convert glittering generalities into practical action: to achieve and maintain the necessary fiscal discipline, to make responsible tax reduction and reform a reality, to conserve energy and increase domestic sources, to tackle the regulatory maze. But I also know there is no escape from facing up to the many difficulties. Our policies must be coherently directed toward the longer range needs. In that connection, I believe that economic policies, public and private, should recognize that the need for discipline and moderation in the growth of money and credit provides the framework for decisionmaking in the Federal Reserve.

The CHAIRMAN. Thank you, Chairman Volcker, for an excellent, thoughtful, intelligent statement.

It now appears, Chairman Volcker, that the administration has conceded that we are going to have a deficit of $30 billion in 1981 and over $60 billion this year. The administration has indicated that they may favor a tax cut next year. Governor Reagan indicates that he favors a tax cut right now and certainly would favor one next year.

CONTINUED DEFICITS

It appears that whichever party is in office next year, there's likely to be continued deficits and those deficits may continue throughout the 1980's.

If they do, what would be the effect on monetary policy and inflation and interest rates?

Mr. VOLCKER. Looked at in the kind of longer-term context you suggest, Mr. Chairman, I think there is a basic tradeoff, if you will. If deficits persist, interest rates will be higher than they otherwise would have been at a given rate of growth in money and credit. And if you assume—a desire I think is there—that you want to bring down and will bring down, over time, the growth of money and credit to noninflationary levels, you run into the problem that inappropriate fiscal policies would put pressure on financial markets, and, therefore the presumed and real benefits of tax reductions—and I think the benefits can be very real in the proper circumstance—would be offset. You tend to run into situations where you could create even more concern due to the process of expectations on inflation and expectations of impact on financial markets.

The CHAIRMAN. So the ideal thing would be for us to reduce the increase in spending if we could so we could have some anti-inflation tax reduction and at the same time reduce the deficit and head toward a balanced budget?

Mr. VOLCKER. That would sound to me the logical approach.

The CHAIRMAN. It's extremely hard to achieve. Everybody favors it. It's hard for me to understand how all that can be done with a rapidly growing military budget. Maybe it can be.

Mr. VOLCKER. You referred to the larger deficits, Mr. Chairman, which I think deserves mentioning, but it's important to keep them in some perspective too. I think there is a different analytic conclusion to be reached, depending upon the degree to which that increased deficit arises as an automatic byproduct of the recession and its impact on revenues—and, indeed, in some cases its impact on spending—and the degree to which it arises out of forces of a continuing nature.

I interpret those recent figures as showing some of each—more the inflation than a basic change in spending trends, but there's at least some increase in spending of a noncyclical nature.

The CHAIRMAN. In your statement you say, and I quote, "I have seen relatively little discussion in the current context of how tax reduction plans might be brought to bear directly on the question of wage and price increases."

This is a kind of a gentle wave in the direction of TIP—tax-based incomes policies?

Mr. VOLCKER. Right.

The CHAIRMAN. TIP is something, as you know, that is supported by one of your Governors and prominently, Governor Wallich, and also by the late Arthur Okun and many of us think it has great promise, but it hasn't had much push either in the administration or much enthusiastic response here on the Hill.

Do you think this is something we should give more earnest consideration to that has real promise?

Mr. VOLCKER. Let me amplify what I had in mind with that comment. In part, I had in mind precisely what you have mentioned. I, myself, do not believe that thinking has developed to the point that there is a proposal; and perhaps there could not be a proposal, certainly in the short run. Maybe in the longer run it makes administrative sense as well as economic sense. I think the TIP idea is a useful thing, however, to continue to explore and think about.

In the shorter run, I also had in mind that we have, at least in recent years, been going through this procedure of establishing a wage guideline each year, which has increased recently rather than decreased. I'm impressed, let me say, with the arithmetical necessity, not just the economic necessity, of turning the wage trend around if we are going to achieve price stability. We are heading into a period and going to continue to be in a period where the volume of money and credit is going to be, I expect, pushed along a path of some decline, if wages continue to go up and other costs continue to go up in that context, sooner or later we will have a kind of collision.

The CHAIRMAN. Now, you have said again and again that you are against mandatory wage and price controls.

Mr. VOLCKER. That's right.

The CHAIRMAN. On the other hand, some people would argue that some forms of TIP, if it is a sharp punishment for those who increase wages above the guideline or a reward for those who hold it below the guideline, are a kind of mandatory wage and price control enforced by a fine or a benefit paid through the tax system.

Mr. VOLCKER. The word "control" means different things to different people, I suppose. Certainly a tax is mandatory, but it's not a prohibition in the sense of administrative control. I haven't seen all the problems reconciled in a way that I can say, "I've got a plan here and I wish you would enact it." I haven't seen anybody else with a plan that I could say looks like it would do the job.

However, when in fact there has been and continues to be a Government program to negotiate some kind of a wage guideline and price guideline, I certainly think we should take into account the need for winding down this process. I think it's totally inconsistent to talk about a program that permits—permits is too strong a word—that points toward successively higher wage and price increases and also expect to get rid of inflation, at least without much more pain than would otherwise be involved. They ought to be talking about the reverse.

The CHAIRMAN. Senate Concurrent Resolution 106 which Senator Garn and I cosponsored is an indication that Congress is willing to support the efforts of the Federal Reserve to foster rates of growth of monetary aggregates that would be noninflationary. It further says that the Congress would like the Fed to pursue policies over the remainder of 1980–81 so as to encourage reductions in the rate of inflation and expansion in the rates of growth of the monetary and credit aggregates appropriate to facilitating economic growth, and therefore to work toward establishing long-run rates of growth of money and credit consistent with the economy's long-run potential to expand output and productivity in order to promote full employment, balanced growth, and price stability, by gradually reducing the rates of growth of the monetary and credit aggregates in a firm and stable manner.

GRADUAL REDUCTION IN MONETARY GROWTH

Now this committee in its last report recommended that multiyear objectives for a gradual reduction in monetary growth be established by the Open Market Committee. Yesterday we heard your former colleague, Mark Willes, say that the Fed has rejected long-run targets because you feel such targets would hamper your flexibility. He also said that in his judgment the cost of flexibility far exceeds the benefits.

The problem we have is that we want to have some stability in the economy, not the stop and go policy, so that uncertainty and disruptions can be avoided.

Does the Federal Open Market Committee support Senate Concurrent Resolution 106? If we pursue passage of this resolution, would you recommend to the Open Market Committee that they adopt a multiyear strategy to gradually reduce the rate of growth of monetary aggregates as called for by the resolution?

Mr. VOLCKER. My reading of that resolution—and it is obvious you're the author and not I—is that I see a certain familiarity in the language in the sense that it reflects what I think we're already trying to do; that resolution, I think, is a fair reflection of our own intentions and a congressional expression of opinion on that point.

I certainly would not resist it. I don't think, I hasten to add, that it's absolutely necessary. I wouldn't want to get into a debate about language that seemed to constrain us or would be contrary to the general sentiments that this expresses; this language is fine.

The CHAIRMAN. Well, now let me turn to your report because I must confess that I am a little confused by it.

In it you say that the Federal Open Market Committee at its July meeting reassessed the ranges it had adopted for monetary growth in 1980 and formulated preliminary goals for 1981. Then the report goes on to indicate that the target ranges for monetary growth in 1980 were retained. But, and here is where I have a great deal of trouble, the FOMC did not set any target ranges for monetary growth in 1981—none—even though section 2A of the Federal Reserve Act requires that such ranges be transmitted to Congress. All the report says is the following:

> The FOMC reiterates its intent to seek reduced rates of monetary expansion over the coming years, consistent with a return to price stability. While there is broad agreement in the committee that it is appropriate to plan some further progress in 1981 toward reduction of the targeted ranges, most members believe it would be premature to set forth precise ranges for each monetary aggregate for next year * * *.

This behavior on the part of the FOMC is then justified on the basis of the great uncertainty in the economy. As I said, the Federal Reserve Act requires you to state the FOMC target ranges for the aggregates, and the intent of the law is to have those target ranges available to us in order to make it easier for everyone to understand your monetary policies and help all of us plan ahead, including the Congress, the administration, and the private sector.

We certainly welcome your commitment to act in the future, but without explicit numerical target ranges, how can we judge how good that commitment really is? Is the FOMC saying, "maybe we can reduce money growth next year, we sure would like to, but maybe we can't, so let's wait and see because surely everyone will trust us?"

How do you defend the withdrawal of the FOMC back into a cloud of secrecy? How good is your commitment? History is against you, not on your side. And the section 2A Federal Reserve Act and the legislative history of the act are also against you. Why should we even consider Senate Concurrent Resolution 106 if the Federal Reserve will not even make an explicit commitment to policies in 1981?

Mr. VOLCKER. Let me tell you a little about our thinking in that connection. I think members of the committee reviewed this question with great care, and the sentiment was very strong that we should not set forth precise numerical targets for next year for the reasons I will explain.

So far as the law is concerned, let me say that we do not read the law and do not believe there is a basis in the law for requiring a numerical target. The law speaks to the objectives and plans of the Board of Governors and the Federal Open Market Committee with respect to the ranges of growth or the diminution of the monetary and credit aggregates, and we think this report certainly speaks to our plans and thinking in that respect. In fact, my own feeling is that compared to last year's report, it's a rather fuller report of what our thinking is.

What it is meant to convey, and what it does convey, is the intention of the committee to plan for reduction of the targets.

Now there are two problems that arise in that connection. One is a technical problem, but it's a problem of very great severity next year with respect to the M-1 totals. We will have NOW accounts introduced at the turn of the year in accordance with the act passed earlier this year. We have widely differing estimates as to what the impact of the introduction of NOW accounts will be on the relative trends of M-1A and M-1B. That's why we established these two measures, because we knew they would be differentially impacted.

The staff has looked at this issue as carefully as they can. There isn't much to go on. This is a major institutional change. We have had estimates that growth in M-1A might be depressed by between 1 and 5 percent by the introduction of NOW accounts—that's because of the money that comes out of demand deposits and goes into NOW accounts—and that's a wider range than we typically use in setting forth these targets.

There are similar questions as to how much will come out of savings deposits into M-1B. As we look at what's happening in 1980—certainly speaking to date—it appears that the differential between M-1A and M-1B is somewhat larger than we estimated at the beginning of the year. We debated whether we should change this year's targets to reflect that large a differential, and we decided it was not significant enough to require a change in the targets. But it seems pretty clear that M-1A is going to come out relatively low compared to M-1B, in terms of the targets.

Frankly, it's very difficult, because of the NOW accounts which are going to come into place, to set forth a target at this time in which we could have a great deal of confidence or that would not be confusing because we are uncertain about the impact, at this time, of this change on the aggregates.

IMPACT OF MONEY MARKET FUNDS ON THE MONEY SUPPLY

The other question of a more or less technical nature goes to the impact of money market funds, which are by all odds the fastest growing financial institutions—if you call them institutions—increasing at annual rates of 100 percent or so. They have some of the characteristics of transaction accounts, and therefore bear upon the amount of M-1, as well as to some degree bear upon the amount of M-2.

Now, looking at those technical factors—and, of course, always wanting to look at things as close in time as possible to when the need for a target becomes operative—we find we don't have an operative need for a precise target at this point. We do for 1980, because that's the way we operate. We don't need it for 1981 yet. We believe the less confusing and most sensible thing we can say at this point, taking account of these technical distortions, is that we are going to work toward reducing those targets next year.

Now understand what reducing means in the case that I cited, particularly for M-1B. If, indeed, there were a great shift from savings deposits into M-1B, that figure would look artificially high for one year, simply because of an institutional change. In that sense, it may be that the more significant figure—at least initially, as we see how this institutional change takes place—may be M-2, and we may have to put more emphasis on M-2 next year.

The **Chairman**. My time is up. I'll be back. Senator Garn.

Mr. **Volcker**. These technical questions which are very difficult for us to wrestle with should not obscure the conceptual intent which we tried to emphasize in this report.

Senator **Garn**. Mr. Chairman, I certainly understand your explanation. I would just say that in the law it says:

> Include a statement of the Board's objectives and plans with respect to the ranges of growth, diminution of the monetary and credit aggregates for the calendar year following the year in which the report is submitted.

Now I recognize there are a lot of new factors to consider—NOW accounts, share drafts, all the changes that are going on from the Deregulation Act of 1979. But still, if I have learned anything else since I have been on this committee, it's that perceptions are incredibly important about what happens in the economy.

I'm not as interested in the exact targets, but perceptions about what is going to happen next year. If we come out of the recession I don't want to bounce back into another big inflationary cycle and what the chairman is talking about is the ups and downs of the economy. Again, I'm not as interested in you saying specific figures, but that there be a perception around the country that the Federal Reserve knows what it is doing, that they have a plan, that they do intend to reduce those aggregates and those targets and they mean it. That's why I'm not totally satisfied with the report, because I don't think it is nearly as specific as it should be according to the law. I don't think it gives the confidence that we need for a continued, longer term attack on the problem of inflation.

And until we get that, I don't know that we are going to solve it because the general attitude around the country is that the Fed is vascillating, that they run back and forth, that they are chasing the inflation or the recession. Until that perception is changed and there's more consistency, I think we are going to have some real difficult problems.

Mr. **Volcker**. I fully understand and agree with all your premises. I agree to some extent with the last comment you made that this is a confusing period and perceptions of what we are doing have been not as certain as I would like to see them. I directed my statement toward those concerns and I think my only point of disagreement is whether it's helpful or harmful to set forth a specific numerical range in 1981, given those problems that I cited in response to Senator Proxmire.

Senator **Garn**. I agree with you. I'm not as interested in specific numbers as I am in a statement of a firm intent and the perception that you will follow through with that intent.

Mr. **Volcker**. I want to reflect and emphasize that intent and I hope the perception comes through.

The other point I want to make is that as we move in that direction, if everything else in the economy moves in an inflationary direction, we can get a collision. People ought to realize that we ought to move in that direction and that we ought to be working on policies to minimize that collision.

Senator **Garn**. The committee, as you know, this year adopted a recommendation that the Federal Reserve should limit the growth of money and credit in a firm and stable manner. That's a very general statement and I think it's very important however that the perception that you are doing that take place.

But let's get back to 1980. I'm concerned about the targets for 1980 because the basic measures of the money supply—M-1A and M-1B—grew much more slowly in the first part of the year than they had last year or they are now. So in order to achieve the average growth target for the whole year the money supply will have to grow much faster during the rest of the year. I'm concerned that you're not going in a firm and stable manner.

The Congressional Research Service calculates that M-1A would have to grow at a rate of 6.7 to 11.9 percent and M-1B would have to grow 6.5 to 11.5 percent in the second half of 1980 to achieve the annual targets.

So my point is that because it's grown so slowly in the first half of the year, you are going to try to average out for the year and you will go beyond the growth target in the second half just to catch up. Aren't we causing some problems there?

Mr. VOLCKER. We have had a period where in the very first part of the year the aggregates were growing more rapidly, then they took a nosedive in April, and then in the latter part of May and June—the current trend—they came back on track. But the Committee quite deliberately decided that it didn't want to force the M-1's up on track just as rapidly as it could, that in the end that would be more confusing, lead to more uncertainties. We obviously had a decline in the demand for money of exceptional proportions in April. In a sense, the equations went off track; past relationships went off track. The committee members have indicated that in the light of all the circumstances—including the fact that M-2, if anything, was moving into the upper part of the range—they do not feel at this time that they necessarily want to force the M-1's back to the midpoint; we would be satisfied, knowing what we know now with an M-1 performance that would fall below the midpoints. Therefore, perhaps you don't have to have as rapid growth as those calculations you recited, which may have been based upon the midpoint. In fact, we are having growth in M-1 figures now; the M-1B figure has been very closely approaching the lower part of its range in the past week or two. But we do not feel that we want to push that right away to the midpoint at the expense of, let's say pushing M-2 over the top.

Senator GARN. Well, I agree, and that's my point. With such slow rates in the first half, I don't want the target rates for the second half to go up too far and rekindle inflation as we are getting out of the recession.

Mr. VOLCKER. Right.

CRITICISMS

Senator GARN. Let's turn to another subject. In March of this year you took the extraordinary measure of adopting credit controls under the direction of the President as allowed by the Credit Control Act. Witnesses yesterday were very critical of excessive restraint from the Federal Reserve. Dr. Allan Sinai of Data Resources said:

> The initial stage of the current recession is the deepest since the 1930's, to a large extent the result of overkill in monetary policy that took place between last October and March.

Dr. Robert Parry, with Security Pacific National Bank, said:

> The credit policies adopted as part of the President's March 14 anti-inflation program were a mistake. They added considerable downward momentum to an economy that had already peaked in January.

How do you respond to these criticisms of the credit controls?

Mr. VOLCKER. You've got to put yourself back into the situation as it existed then. We had a situation in which inflationary expectations and perceptions were accelerating in a rather massive way. There was a very high level of borrowing. The aggregates at that point were moving to and above the upper end of the targets. So we felt, as I indicated, that restraints had to be placed upon this kind of growth.

You may recall the many reports that were common in the money market about the continuing free availability of credit, at least to larger businesses—at higher rates to be sure, at sharply higher rates. The banks were not aggressively, shall I say, resisting loan requests at that time from larger customers. They were in a competitive situation where they apparently basically felt unable to say no to borrowing requests from these larger customers because they were concerned about long-term customer relationships. They were concerned that if they said no, the fellow down the street would say yes, and they would lose their customer not just for 3 months but for an indefinite number of years. So there was a question in our mind, as in many minds, as to whether we were getting enough restraint on bank loan expansion, to larger customers at least.

The purpose of the special credit restraint program was to break into that process and to avoid putting all of the pressure on the interest rate level. The alternative in some sense was seeing interest rates go still higher. That was a major element in the March 14 actions, and I cannot say that that was a wrong analysis; even with the benefit of hindsight I think it was correct.

Now the consumer credit program is a somewhat different case. Consumer credit had begun to slow before March 14, but there's no doubt that the level of consumer spending relative to income was very high and that consumer debt positions were becoming strained. The determination was made, in the first instance by the President's invoking of the Credit Control Act of 1969, that, in effect, a signal should be sent to the American consumer. We, in fact, took the mildest action that we could conceive of, but there was clearly a psychological message.

Senator GARN. It certainly was. My point is, I agree with what you said about the situation in October, November, December, January, but it really appeared to me—and we discussed this at the time with many economists—that by March 14 things really were starting to go the other way, coming down, and then you hit them with this psychological approach which really spiraled it the other way too rapidly. A lot of people think it would have turned around without that.

Mr. VOLCKER. I think eventually it would have, but the question is how much damage would have been done in the interim through a kind of further escalation of inflationary expectations and high monetary and credit growth?

If you say it would have been better to do this on February 14 instead of March 14, then with the benefit of hindsight at least, I think that's probably right.

One of the considerations that we had at the time was to coordinate any extraordinary action of this sort with the budgetary program and, if you will recall, that took some weeks to work out.

Senator **Garn**. My time is up, but one quick question if you can answer it quickly.

Would you support a repeal of the Credit Control Act on July 1, 1981, which the Senate adopted in S. 2352? Yes or no?

Mr. **Volcker**. Yes, but let me explain. I do think that is a rather sweeping bit of legislation.

Senator **Garn**. It was intended to be.

Mr. **Volcker**. I think anybody who reads that act and realizes the kind of potential and actual power that it gives the combination of the administration and the Federal Reserve to apply in rather indefinite circumstances some time in the future is going to be a little restive, and I share that restiveness about the sweeping provisions of that act.

I also want to emphasize and will state positively that I think it is a very rare circumstance indeed when we would not want to conduct monetary policy through our traditional tools; there's nothing in recent experience that changes my mind about that.

Senator **Garn**. Thank you.

The **Chairman**. Senator Riegle.

Senator **Riegle**. I won't review all the current statistics on inflation rates and economic conditions, but will say it's obvious by all measurements that we are in an extremely serious economic situation today. It's not yet clear exactly where we are headed or when the situation will improve measurably.

[Senator Riegle requested the following appear in the record:]

The Economy

The U.S. economy has slid into the deepest downturn for the first quarter of a recession since the 1930's with real GNP off 9.1 percent in the second quarter.

The unemployment rate has soared to 7.7 percent from 6.6 percent in 4 months, with an additional 1.5 million persons unemployed since January.

The unemployment rate is projected to peak at 9.0 percent in 1980:1, a sizeable increase from the 5.9 percent of 1979:4. By the fourth quarter of this year, the unemployment rate should be 8.8 percent, representing a rise of 1.7 million persons in the ranks of the unemployed from 1979:4.

Dr. Allan Sinai, Senior Vice President, Data Resources, Inc., testified yesterday that unemployment increased more rapidly in April-May, than at any time since the Great Depression.

Growth in productivity has slowed to 0.5 percent per annum over the past 6 years and was down 1.7 percent during the first quarter.

Current trends include a recession, initially the deepest in the postwar period; sharply rising unemployment; still severe inflation; slow growth in productivity; and relatively high levels of nominal interest rates for an economy in slack.

DRI predicts that despite the relatively long and deep recession that is anticipated, inflation rates will remain at 8 to 10 percent, on average, for most of the next few years.

Since October 5, the dollar has dropped against the yen by 2.5 percent, is also down by 2.5 percent against the French franc, is lower by 1.8 percent vs. the German mark, and is off 8.1 percent against the British pound.

With respect to the domestic economy, the New Fed Policy brought about a full-blown credit crunch with (1) sharply accelerated rises of short- and long-term interest rates, (2) widening yield spreads between the highest and lower qualit debt, (3) intensified disintermediation, (4) a severe squeeze on bank liquidity, (record-high borrowing rates, and (6) deepened financial instability for househol and business. The result was recession.

Consumer prices are expected to average 13.8 percent above last year's level, th steepest rise since 1947. The first quarter showed prices increasing at the fastes rate of the postwar period, a factor that cut deeply into consumer purchasing powe and, thereby aggravated the contraction.

Capital spending is beginning to respond to the economic downturn, with order for capital goods falling in response to declining operating rates and corporat earnings and to historically high financing costs. Although inventories have bee relatively lean compared to sales, recent sharp sales declines are producing a unintended buildup in inventories. Efforts to liquidate inventories should result i second-half declines in industrial output and employment. Meanwhile, a deteriorat ing economic picture abroad is beginning to trim the demand for U.S. exports— sector that previously was viewed as a potential source of strength to the 198 economy.

Senator RIEGLE. The first question I'd like to ask is essentially a process question and then I have some specific policy questions that I'd like to have you respond to.

FEDERAL RESERVE STRATEGY

The process question has to do with the way you, representing the Federal Reserve, are working today with the Carter administration and the economic people within the administration to try to put together an overall economic strategy for the country. Could you describe for us exactly how you are involved, how often you meet. Are there periodic meetings each day or several times a week or once a week? How do you go about integrating and meshing monetary strategy with overall economic strategy?

Mr. VOLCKER. I am speaking for myself because the principal liaison here does lie with me, of course. I see the principal economic officials of the administration—the Secretary of the Treasury, the Chairman of the Council of Economic Advisers—typically once a week, sometimes more frequently; we try to make sure, even if nothing special is happening, that we touch base at least once a week.

I try to take advantage of those opportunities to tell them how we see things evolving and certainly what our own basic approach and strategy is. I don't think there's any question on their part as to how monetary policy is evolving. They may tell me something about their own thinking in different areas.

That does not mean that we are involved on an organized basis with the kind of planning that this administration or any administration would do on developing a specific tax program or economic program more generally. I think there are opportunities, to the extent they see fit, where our thinking can be fit into that planning, but we are not on task forces, and we don't participate in the drafting of administration programs in the ordinary course. We try to be aware of the direction of their thinking.

Senator RIEGLE. Do you feel that the overall economic strategy of the administration is compatible with and well synchronized with today's monetary policy?

Mr. VOLCKER. I do not think the budgetary situation, in a sense, is as well synchronized with monetary policy as I would like to see it, but let me distinguish the facts of that situation.

From what I understand to be the intention of the administration, they have been working—and it's reflected in their public statements—toward achieving as much restraint on the spending side as they see feasible, looking ahead. They have in mind planning for a tax reduction in that kind of context.

In that context, I don't think it's incompatible with what we are doing. I have emphasized to them, as I would emphasize to you, that if we are going to reduce these monetary targets—and that is our intention and policy—that whole process in the economy is going to work more smoothly to the extent that all instruments of economic policy are working in the direction of reducing price and cost pressures; I would think that's the principal emphasis that I would bring to these discussions at this point.

Senator RIEGLE. Do you have any major disagreement with the economic strategy that you see being carried out today by the administration or, conversely, have you received any indication from the administration that they feel any part of monetary policy is at odds with what they are trying to accomplish? I hope you will be frank with us on this because this is a critical time and we are trying to get everybody's best judgment to bear on this problem of how we improve the economic situation.

Mr. VOLCKER. On the latter, the answer is clearly no.

Senator RIEGLE. Could I infer from that that you are getting signals of support for what you are doing in the monetary policy?

Mr. VOLCKER. I haven't had any objection.

Senator RIEGLE. I know that, but that's different from support.

Mr. VOLCKER. I have a little trouble in this area only because we are independent of the administration, and, in a sense, I don't look to them for support or objection. I try to keep them informed, and I think it's fair to say I have no sense of objection.

I don't ask, "Now, do you really support this? Are you eagerly in favor of what we're doing?" I haven't had that kind of a conversation.

POSSIBLE TAX CUT

Senator RIEGLE. Let me ask you a specific question then that goes to the issue of policy. There's a lot of discussion about a possible tax cut. You touched on it lightly in your comments today. If there were a tax cut of whatever size and content—how could we be sure that the monetary policy then wouldn't be adjusted in a sense to sop up the additional moneys that would be made available by the tax cut? How could we be sure there wouldn't be a change in monetary policy to in fact cancel out the effect of the tax cut?

Mr. VOLCKER. I don't think there's any reason for anybody to be uncertain about what the general tenor of our policy is; that is, we aim to restrain growth in these monetary aggregates and work toward reduction of inflation, and that is true whether or not there's a tax cut. In a sense, I reverse your question. Our policy is an element that I think needs to be taken into account in planning for a tax reduction and in fiscal planning in general. One of the possibilities you have, if the planning is not appropriate, is that it leads not only to a bigger deficit but to expectations of bigger deficits in the future. That will have consequences on developments in financial markets that are inescapable. I don't think the answer to those problems is saying, "OK, the Federal Reserve will conduct an inflationary policy."

Senator **Riegle**. I think this is a key issue. Let me put it to you this way. Most of the talk now is that if there is to be a tax cut it might come around the turn of the year maybe to coincide with January 1, but I would think that under some circumstances it could conceivably come sooner than that. That's the general consensus at the moment.

If we were to work with that as a time frame what would be the general size, or range of tax cut that you feel would be compatible with your own monetary goals, and would not throw things so far out that you would feel that you would have to be more restrictive to try to offset it?

Mr. **Volcker**. You've got to tell me what the expenditure level is and you've got to give me some sense of what the economic circumstances are at the moment.

But, again, in terms of us being more restrictive or less restrictive, there is nothing in that situation that in itself would bring about a different monetary target than we otherwise would have. What might be different is what happens to interest rates, to credit market conditions. But I'm not using that as a measure of policy; if I interpret policy as I think is appropriate now in terms of growth in money supply and monetary aggregates, there should be no presumption that these will be changed with or without a tax cut.

Senator **Riegle**. You have the same current data available to you that we do in terms of the midyear analysis and you have to make your own forecasting judgments and decisions based on what's available now. You're required to do it and you have to do it just as a practical matter.

Mr. **Volcker**. Right.

Senator **Riegle**. If we're talking about a tax cut in the aggregate of say $40 billion, is that something you would view to be generally compatible with your monetary targets?

Mr. **Volcker**. I doubt it, as best I can see today, with the uncertainty that I have about expenditure trends. I would be loathe to say that that's compatible with satisfactory developments in the economy, including the need to reduce inflation.

Senator **Riegle**. Is the inference that that would be too high?

Mr. **Volcker**. Too high, yes.

Senator **Riegle**. What about $30 billion?

Mr. **Volcker**. I can't be pinned down to a number. I'm not ready to say we need a tax cut.

Senator **Riegle**. The reason I think it's important for us to probe this, is that, we have an economic task force at work here in the Senate to try to develop specific tax recommendations. We have already committed ourselves to report that out of the Finance Committee by the first week of September. That isn't very far away so I don't think we can afford to play cat and mouse with one another. I'm not suggesting that you're doing that today, but I think we'd better have some pretty direct and forthright discussions as to what looks like an accommodatable amount because if it were to be the intent of the Federal Reserve to offset a tax cut, I think we need to know that now so we can introduce that into the debate.

Mr. **Volcker**. It's not a question of "offsetting," in the sense that you put forward. I think you ought to fix into that thinking the idea that the Federal Reserve should be moving during this period toward reduced rates of credit and money growth. I think there's been, in a general sense, a consensus on the desirability of that policy. All our statements today are reiterating that policy.

Now, in that sense, it's a fact of life that should be taken into account in this kind of planning. I don't know what the situation is going to be at the end of the year, but it's clear that the thrust of all those discussions should be, if we're going to have a tax cut at all, how can we make that cut most effective and most consistent with the need to increase productivity and reduce cost and wage pressures.

To the extent that those elements of tax reduction are maximized—and let me assume all the other criteria of expenditure control and all the rest are in place—to the extent that those criteria are maximized, you know that you have a package that will be most realistic in terms of fitting into the available supply of credit and money and having maximum favorable impact on the economy.

If you just go ahead and make a tax cut, a general purchasing power tax cut, it will aggravate the possible collision that we are going to have between restraining monetary growth and the need for economic expansion.

Senator **Riegle**. Then the time is now for you to be more specific with respect to what you would like to see us consider and recommend. I'm not saying in the next ten seconds, but I am saying that the time is here for the debate to get specific. We have high unemployment. I would hope that somewhere in the policy mix there's a consideration that's going to bring down the unemployment rate because we're not going to do much about the deficit if unemployment stays this high or is rising.

Mr. **Volcker**. The problem we have, Mr. Riegle—and I think we're obviously on a very important point—is that we don't want to be faced with, and the country doesn't want to be faced with, a situation where, in effect, all other public and private policies are going hell bent for inflation and we come along and say, "Look, we're cutting the supply of money and credit." Those two policies are inconsistent, so if you say the answer is for us to increase the rate of employment and reduce unemployment by blowing up the money supply, I have to tell you I don't think that's going to work. It's just going to give us a bigger problem in the future. We're going to be right back in the kind of soup that we're in now.

We've got to get out of that kind of bind and we're not going to get out of that kind of bind unless other policies are consistent with this need to wind down inflation. If inflation gets down there's going to be enough money and credit to finance recovery and reduce the unemployment rate and finance growth. If all other policies are off in the inflationary direction, we have a problem.

Senator **Riegle**. Well, my time is up. It would be helpful if you would be more specific with us, so that we can search for good constructive public policy.

Mr. **Volcker**. I understand that concern, and I tried in my statement to point to the directions that I think are necessary in a general way. I am also conscious of the fact that the Federal Reserve does not have responsibility for writing tax bills and other proposals, and there's a question of——

Senator **Riegle**. There's a difference between asking you to write it and asking for your specific advice. But my time is up.

Mr. **Volcker**. I worry a little about the word "specific," but I certainly think there are general kinds of considerations that are appropriate, and I would be glad to supply that.

Senator **Riegle**. I think you should give us your thoughts on the size, the timing, and the content.

[Chairman Volcker subsequently submitted the following information for the record:]

I cannot recommend a detailed package of tax cuts to you because a number of critical questions needs to be resolved before the decision should be taken to have any kind of major tax reduction. The appropriate time for decisions seems to me late this year or better yet in early 1981. By then a number of uncertainties may have been clarified, at least to some extent. Tax policy obviously needs to be geared to the outlook for federal spending, and the recent trend of successive upward revisions in spending estimates indicates the large uncertainties in that outlook. By year-end, we will know better where we stand on fiscal 1981 federal spending, and expenditure plans for fiscal 1982 will have been formulated. Moreover, the evolving economic situation also needs to be taken into account in formulating a tax-cut package. Economic activity may well be picking up by early next year, and if inflation should persist at very high rates, tax relief could well be counterproductive. Alternatively, if the recession should prove deeper and of longer duration than now thought likely the case for tax reductions would be strengthened.

In the event of a tax reduction becomes advisable, I would focus it on measures that would have anti-inflationary benefits. In particular, priority should be placed on efforts to stimulate investment, thereby enhancing productivity and reducing business costs. At present there seems to be a consensus around some form of liberalization of depreciation allowances, and I share the view that such an action would provide an effective incentive to investment. Another anti-inflationary tax reduction that has received attention is some form of rolling back part of the social security tax increases scheduled for January 1981; such action for persons would provide more spendable income than otherwise and eliminate a rise in unit labor costs. However, the revenues of the payroll tax are needed for the integrity of the trust funds, and in terms of my own philosophy I would not break the linkage between social security benefits and payroll taxes.

From the standpoint of ameliorating rising tax burdens, I would welcome a cut in individual taxes. However, there is limited scope for individual tax cuts given the state of growing federal expenditures and our problem of inflation. If such cuts are given consideration, I would urge that the possibility be explored of tying the tax cut in some fashion to slower growth of wages. Although this may prove difficult, it is essential that our efforts at this juncture be directed to gaining control over inflation.

The **Chairman**. Senator Kassebaum.

NOT ENOUGH COORDINATION

Senator **Kassebaum**. Maybe to follow along with that, Chairman Volcker, do you feel there's not enough coordination between the monetary policy and the fiscal policy? I would gather from your opening statements that you do feel that monetary policy as it has been followed by the Federal Reserve up to this point has had a dampening effect on inflation and yet we are still battling both inflation and recession.

Mr. **Volcker**. Again, let me distinguish between policies in terms of their intent and what's happening. There are lots of things happening that I would prefer not to happen. I wish the budget expenditures were more closely confined. I wish the deficit were smaller. I wish we had—and I recognize it's an extremely difficult and sensitive area—some way of turning around that trend of cost increases imposed by regulatory concerns, imposed by the social security tax, and, indeed, imposed by private wage and price settlements. I'm unhappy about many of those areas.

If you talk about intent, understanding, in the administration and elsewhere, of the need for working on these problems, I think there is that understanding and I think there is that intent which hasn't always been implemented.

Senator **Kassebaum**. Of course, it's interesting because I suppose in a way fiscal policy is political and you don't have to deal with the political realm as much as we do here in trying to devise a budget that does do the things you would wish it would do, but you mentioned here—I think it's interesting to say the heart of the matter really lies in improving productivity and reducing wages and prices.

Mr. **Volcker**. Right.

Senator **Kassebaum**. How do we get at wage and price decreases when certainly I would think there's general agreement here that controls are not the way?

Mr. **Volcker**. That's a nice question, and it is the most difficult part of this area. Let me say that I think part of the solution I would hope would come from some understanding on the part of the people setting the prices and setting the wages that we are working in a context in which, in a sense, there isn't enough money and credit to go around, and so by pushing the wage trend upward instead of downward we are only aggravating the problem.

Quite specifically, it's very arguable how useful some of the wage-price negotiations and consensus have been in recent years. I happen to think it's had some usefulness, but it's not very useful to have that process continue when it results in rising levels of wages and costs, because that's clearly inconsistent with what the country needs and it's inconsistent with monetary policy.

To the extent that point can be made, maybe we can shape and change the attitudes that go into those decisions. I don't expect miracles, but I do expect that it's possible to begin getting some understanding that makes it possible to change the trend of those settlements, which in the end don't do anybody any good: There's no real income gained in this; it pushes up the inflation rate; it makes the economy work less well; and it decreases income instead of increasing it.

How do we get the consensus that it's in everybody's interest to deescalate this thing? That is what the Federal Reserve is trying to do through its monetary and credit controls—"controls" in the sense of controlling the growth of credit—but that process is going to work a lot more smoothly to the extent that everybody is on board and recognizes the need.

Senator **Kassebaum**. Yet, interestingly enough, and this is where it gets frustrating for everybody, the traditional patterns haven't followed. It doesn't seem to me that from the credit controls we have seen—I think they did have some beneficial effects, but perhaps it hasn't—perhaps it wasn't long enough, but it didn't seem to me it had any effect on prices or wages.

Mr. **Volcker**. On wages it's much too soon to see any effects from anything that's happened. As to prices, wasn't talking about the credit control program, but rather about maintaining control on money and credit growth over a period of time, but I do think what's happened in recent months has certainly deflated the bubble, if I can put it that way. It's taken the froth out of prices, in some sense. What it's done is put prices back to this core rate that is basically controlled by the trend in wages and productivity.

It's hard to shift those trends. Those trends are sluggish. They react slowly. But the important point—and the point I want to emphasize again and again—is that anything we can do to speed up that reaction and instead of having a trend toward declining productivity and having minus productivity, we begin moving back toward positive productivity; instead of having a trend toward higher wage settlements; we begin having a trend toward lower wage settlements—anything that moves in that direction is going to be helpful It's not only going to be helpful in terms of inflation, but it is also the most helpful thing we can do in terms of growth, sustaining growth, sustaining employment and reducing unemployment. There's just no question about that.

Senator Kassebaum. You don't see tax cuts at this time as being an aspect of productivity?

Mr. Volcker. I don't think we have all the conditions in place that make a tax cut a responsible possiblity right now. I don't say that couldn't happen even in a 6-month time perspective. I think it's partly a question of amount; it's partly a question of how that tax cut is designed so as to maximize the effects on productivity. If it can be part of a wider, implicit bargain made to de-escalate cost and wage trends, we will be way ahead of the game.

None of that has been done yet. There's been a lot of talk in a general way. There are some specific proposals on forms of tax reduction that would improve productivity. I think that's all positive and moving in the right direction.

I don't think we have a proposal before us yet that says, "Look, this really is the kind of approach to maximize the increase of productivity, maximize incentives, maximize cost reduction per dollar of revenue given up. I don't know of any tax program that isn't going to give up some revenue in the short run. That's inevitable, and we have already got a problem in that connection. We've got to work on that, on how we get the biggest bang for the dollar, so to speak—not bang in purchasing power, but bang in productivity, incentives. I think we have an opportunity here. I think there is a considerable understanding that didn't exist 5 years ago about this kind of need. I think we have a basis upon which to work, we have got some time to do it. Given the degree of intellectual consensus that develops on generalities, let's convert those generalities into a practical program. Let's recognize that it has implications for spending. Let's see how the economy develops in the next 6 months, and maybe then the answer will be "go." But I'm not ready to say go now, and the answer may still be no if these criteria are not met in the next 6 months as far as my own opinion is concerned.

Senator Kassebaum. Thank you.

The Chairman. Senator Stewart.

Senator Stewart. In response to Senator Riegle's question and Senator Kassebaum's questions, you set out certain criteria for a tax cut that would fit perhaps within the overall monetary policy framework. What are your thoughts about the tax cut that was recently proposed by Governor Reagan and others—this 10 percent across the board cut? Does that fit your criteria?

Mr. VOLCKER. I don't like particularly to be drawn into——

Senator STEWART. I certainly wouldn't want to do that.

Mr. VOLCKER. It's fair from what I have said to infer that I do not think we now have the criteria in place that I see as necessary for a tax cut of that size and, particularly, for a tax cut that not only has a large revenue impact in fiscal 1981 but an impact that multiplies rather rapidly in subsequent years. I have not seen the spending program and the spending commitments that go along with that kind of tax program at this point.

10-5-3 PROPOSAL

I don't want to pose as an expert on every detail of tax law, which I certainly am not, but I have looked to some extent at the 10-5-3 proposal. I think it is fair to say that that has some problems with it, even if one accepts—and I think there is a very powerful argument for accepting the idea that depreciation reform is a very promising avenue and this proposal goes in that general direction. When one looks at the details, including the size of the progressive revenue loss over a period of years and the differential impact on different industries and different sectors of the economy, I think it's highly probable, shall I say, that even if depreciation reform is a reasonable premise—not the only way to go, but one possible way to go—that bill could be improved.

Senator STEWART. You're talking about the 10-5-3 specifically?

Mr. VOLCKER. Yes.

Senator STEWART. There's been some talk that the tax cut would be in part a supply side tax cut. I don't know what the figures would be, but I think it would be an improvement perhaps over the 10-5-3. I just wanted to know what you're talking about.

Mr. VOLCKER. There are other ways of attacking the investment problem which I think is central. There's been a lot of discussion of depreciation, and I think that is a promising way to go, but that's not to endorse the 10-5-3.

Senator STEWART. The other thing I wanted to ask you just to make a comment about, in your statement somewhere you indicated that one of the difficulties that we were having in our economy was caused by the regulatory morass that people find themselves in as a result of regulations that are promulgated by Federal agencies.

I don't know whether you realize it or not—and this may come as a shock and surprise to you this morning—but in traveling through my State over the recess period, I had the opportunity to visit with certain financial institutions and they have become increasingly concerned about the burden that's being placed on them by not only other regulatory agencies but also from time to time by the Federal Reserve.

Mr. VOLCKER. That doesn't surprise me a bit.

Senator STEWART. They weren't as nice to you as I was. I have become concerned about the omnibus banking deregulation bill which set up the depository institutions deregulation committee.

Many people within the financial community are very much concerned about the regulations that are being imposed by that deregulation committee.

What efforts are you making to actually deregulate in the are that you're responsible for? Because those costs, as I understand i are not only borne by the financial institutions but they are als borne by the customer and they are also passed on to individual

Mr. **Volcker**. No question.

Senator **Stewart**. And I believe in cleaning around your ow hearth before you make a change in another area.

Mr. **Volcker**. I agree with that fully. Let me suggest somethin about the kind of problem we have in general, and then I'll tal about the Deregulation Committee in particular if you would like

One of the more appalling things to me upon taking this job while I was not totally unaware of it before, was putting ou regulation Z, which implements a bill sponsored by the chairma some years ago. Who can quarrel with the idea of truth in lending that lending institutions ought to be straightforward in providin information on lending terms? They ought to do it in a way that' explicable to the customer. The idea had its day in Congress 1 years ago I suppose. Since the bill was passed, it has been amende a number of times.

What I found when I arrived in office at the Federal Reserve was that there are 189 pages of regulation and 457 or so interpretative rulings, and that's appalling.

I thought I'd better read the regulations we have; I still haven't been able to get it. I have enormous sympathy for the banks that have to cope with that. The truth in lending simplification bill enabled us to put out a new regulation for comment.

Senator **Stewart**. That change by the way created a lot of problems.

Mr. **Volcker**. That's right. The mere change creates problems. I think this bill has simplified things; it is an important step forward. But the mere fact that you have to change something so detailed as that creates a lot of new problems. You've got a bank out there that has 15 employees, and it can't have a full-time employee reading regulation Z. I'm told, and I believe it, that we could probably get 90 percent of the effect of that regulation with 5 percent of the language, but there would be another 10 percent which we miss. I think that's the direction in which we should go, but the law doesn't permit us to do that now. I assure you that even if the law were changed, the 10 percent that we would still miss or the 5 percent that we would still miss is going to give rise to a lot of letters to Congressmen and Senators saying: "In this particular instance that I have the rate was not revealed in precisely the right way;" or "I had an especially complicated deal that didn't fit into the tables or formulas that are ordinarily given and the bank didn't calculate the simple rate of interest correctly and maybe didn't even attempt to." I think that kind of pressure has led, rather than to simplification, to another interpretive letter or another provision of the law that closes that so-called loophole. We have a contest between these two desires: the obvious need to simplify and the pressure to respond to a particular problem at a particular time.

I think we have lost that battle, in a sense, so far. The world may be turning a bit in truth in lending because we do have a simplification bill, but we could, frankly, write a much more sweeping simplification bill that would do fine and permit a really drastic simplification, if Congress is so willing, but we can't do it without a change in the law.

I'm sure we could repeat that kind of situation in many, many areas. I can't give you examples in the environmental or safety area, but I'm sure you're familiar with the complaints that regulations, however valid in purpose, very often reach a point in detail or cost ineffectiveness that is not justified. It's extremely difficult to work through these problems. It takes a certain amount of good faith, I think, on the part of the Congress and the various interest groups involved to achieve the results. But I don't see how we can fail not to try to move further in that direction. I only used one example of what we have; we have lots of others.

Senator **Stewart**. Well, my time is almost over and I don't want to belabor the point, but I do think and I suggest to the chairman that we discuss it. I saw a series of documents that would be used in the closing of a conventional loan.

Mr. **Volcker**. That's another regulation.

Senator **Stewart**. They were 100 feet in length. They were attached end to end and we rolled them out and measured them and they were 100 feet and I don't know where all that stuff is kept, who reads it or——

Mr. **Volcker**. I don't know where it's kept, but it comes from a law that the Congress passed.

Senator **Stewart**. Well, now, let me just comment about that and I'll be glad to. As I said, I was in the State and a lot of people maligned regulators from time to time, but I don't think there's any question but it was an implementation of a congressional action, but I would not hold you harmless or blameless, as I referred to earlier. I have written you about some actions that were taken by this deregulation committee that were done without any real understanding at all of what impact it was going to have. I don't know a Member of Congress that necessarily asked you to do that.

DEREGULATION COMMITTEE

Mr. **Volcker**. I think there's been a lot of confusion about that Deregulation Committee action. It's complicated because we stepped into a complicated situation, we have had I don't know how many different types of——

Senator **Stewart**. Some of the laws we passed deal with complicated situations.

Mr. **Volcker**. The world is complicated.

Senator **Stewart**. And my time has run out.

Mr. **Volcker**. I understand why the laws are passed. But if I can comment briefly about the Deregulation Committee, because I think there's been a particularly great amount of confusion. It looked complicated because we announced a whole series of changes at one time; when you announce them one at a time they don't look so complicated.

I think sight has been lost of this point, that the basic thrust of those changes that were made was to put all these institutions into a better competitive position relative to the market, so to speak—relative to Treasury securities, relative to money market funds—and permit them more freedom to compete. We did that simply by raising the ceilings relative to the Treasury securities to which they are linked.

It sounds complicated to have a floor and a ceiling, but the thrust of having a floor and a ceiling is to say to institutions that if interest rates get low enough and you're not going to have any earnings problems, the Government doesn't have to tell you precisely what rate to pay. At those levels, you take care of yourself. We just said that at some point rates are low enough so that it's in your own interest, in competing in the market and in not having detailed regulations, to let you be free.

Other aspects of the regulation were directed toward the problem which creates all the attention among the trade associations involved; that is, how well do I do relative to other institutions? We made some decisions that we thought were focused not so much on what's fair to a particular institution; rather, we wanted to help the various sectors of the economy in a reasonable way, to promote the flow of funds into housing without damaging the flow of funds to farmers in Alabama and automobile dealers and all the rest who are dependent on small banks. So, we made some judgments as to the pattern of those rates, which in any event were required by law during the phaseout period.

I think we made a little progress toward deregulation, complicated as it looks, and I'm not going to say——

Senator STEWART. All I would ask you to do, as a final comment, is to do exactly what we're trying to do or what I hope we're trying to do, get more understanding of what impact laws, regulations or anything else have.

Mr. VOLCKER. That's the point here. As far as the complications of regulations are concerned, I'm perfectly aware that Congress passes a law and, to some degree, the better the people in the agencies that apply the law, the more complicated they make the regulations because they think of all the possible exceptions and unique circumstances. Then you send the regulation out to the banks, and I must say that a typical comment by the bigger banks that have high-priced legal talent is, "Here's another complication for you. Write another section in the regulation to cover this situation." It's a kind of insidious process in which we all participate, and we end up with very long regulations.

Senator STEWART. My time is up.

The CHAIRMAN. Senator Lugar.

Senator LUGAR. Thank you, Mr. Chairman.

During your answer to other Senators' questions I was jotting down a number of the things that you indicated were unhappy facts of life quite apart from the elements you can control and among those were the size of the budget deficit, the size of governmental spending altogether, wage and price policies, social security, regulatory costs, what is now a deficit in productivity. All of these in one respect or another would appear to be items on which the Fed could have only a minimal impact.

But obviously if all of them are operating in an inflationary manner, you're finally left then to try to formulate monetary policy and sort of in opposition to a juggernaut.

Mr. **Volcker**. I think that's a fair description of the way we sometimes feel.

Senator **Lugar**. Now in trying to think of what to do in that situation you have set growth ranges for M-1A and M-1B and M-1 and M-3 and the growth ranges I suspect are reasonable. They were debated at the time I'm certain by you and your associates and reviewed by this committee and Members of the Congress. But just for the sake of argument, given all of the factors that I just listed from your testimony, why should there by any growth range at all? In other words, isn't it the case that if you are to have an anti-inflationary impact that you simply ought to say we're not going to have monetary growth in this period? Why shouldn't it be zero or something lower?

Mr. **Volcker**. I think about that sometimes. Instead of working down the growth ranges over a period of time, maybe the most dramatic thing we could say is that from now on we are going to go right to a noninflationary rate of growth, and the rest of your fellows get in line.

I don't think, obviously, that's a decision that the Federal Reserve has been prepared to make. We have not seriously debated that draconian, single step, but it has the one advantage of waving the flag high and saying, "This is where we've got to get in the end anyway; maybe it's better to do it quickly than not quickly." But I think it implies a very rapid change in all these other factors that you have mentioned, and perhaps a more rapid change than is tolerable at this stage of the political debate. I use "political" in the broadest sense: the public debate and understanding.

LARGE BUDGET DEFICIT

Senator **Lugar**. In other words, your judgment would be colored principally by that and it's understandable. We all try to make these judgments. But the facts of life are that, after all sorts of protestations, the Congress is going to come up with a budget deficit that's very large, now moving into the tens of billions and heaven only knows where that finally will end up and there really haven't been any changes to speak of in the regulatory costs. The productivity deficit is still there. Almost inexplicably large basic industries, some of which we have been dealing with in this committee, are laying off hundreds of thousands of people, losing billions of dollars collectively, and yet wage increases of very substantial size have been negotiated.

Mr. **Volcker**. Sure.

Senator **Lugar**. Now in the face of this, granted there are several of you as Governors and you can't make a unilateral decision, but I sort of have a feeling about all of this, that we keep accommodating each other. You know, we can't hold you responsible for spending and the deficit and what have you, but I just think we've got to come to somewhere else in monetary policy.

Mr. **Volcker**. I think you have described the process that's gone on for some period of time. I do think that is changing and I'm trying to say, that without the taking a draconian, dramatic step that you suggested, we are going in that direction; and that these other trends are inconsistent; and that if there is basic agreement, as I think there is, that this American economy is going to operate better in an atmosphere of price stability and we want price stability for its own sake, then it's necessary that we move in this direction. There's got to be more explicit thinking than there certainly has been about what it means to these other policies.

You pointed out, in a very narrow sense that there are lots of problems in the steel industry and in the automobile industry, structural problems, problems from decisions that were made some time ago. But at the same time, it's probably not totally a coincidence that some of the industries in this country that have the most difficulties have had the greatest wage increases and the highest level of wages in the country.

Senator LUGAR. Shifting just a second to the debate or discussion that we were having on tax policy, it seems to me that just a possible predicament you indicated to Senator Stewart was the one that got caught in the middle of it which is just as well because clearly this is part of the argument of what type of tax reduction we ought to have and both parties are moving very rapidly toward a conclusion of that debate.

I would ask this without going into whether a 10-percent reduction immediately is appropriate and you have indicated 10-5-3 might be improved. What is likely to change the productivity side or what is likely to change, as a matter of fact, what is a tailspin in the economy? The administration would say it's no longer free fall. In fact, there are hopeful signs along the fringes or the degree of fall is less each month than the month before, and that might be right. Certainly they are prayerful that it is. But they may be absolutely wrong. As a matter of fact, we might simply be in a decline that doesn't end in the third quarter or the fourth quarter or even the first quarter of 1981. I don't think this is foreordained at all.

In the same respect that the draconian treatment of going to zero monetary growth sends all sorts of signals, it seems to me that an immediate tax cut sends the right kind of signal too. At least I for one would not be prepared to say that a tax cut should not be enacted simply because it has not been tailored together with, as you pointed out, spending commitments or wage and price decisions, or the different types of industrial situations where 10-5-3 may not fit particular segments of the economy. At the same time, the general policy of the President has been the discussion that this is inappropriate and as a matter of fact, wise men say it would be inappropriate given the fact that it's an election year and Congress has a short period of time and is caught up in the election fever and what have you—that wiser counsel would prevail after all that debris is cleared away, which is fine, if we were not in a free fall or something close to that of economic decline, but we are.

It seems to me that this is the case for taking a very sharp action with regard to tax reduction quite apart from—that is, the 10-percent variety—and the 10-5-3—the thought that somebody in industry might invest in a great deal more productive equipment, sort of begin to get that process going which has been delayed as you pointed out.

Mr. **Volcker**. Inevitably in this kind of discussion—let's take 10-5-3—you're giving out two signals, and you can't separate them because they are inherently connected. One signal is we've got to work on our productivity problem; that's a signal I think we need. The other signal is that we don't worry about deficits; that's going to be counterproductive to what we want to accomplish.

You speak about the economy being in a free fall. That may have been an apt description of consumer spending for a while. There are signs it's coming around. I don't want to put a lot of money on one forecast or another, as you suggested at this point. All I would say is that if it turns out that the optimistic view is correct, it would double the concern about acting now in a big way, particularly if you went beyond what just gives a clear signal on productivity.

That question won't be resolved for some months, and it is a consideration about the relative size of any tax reduction. I just don't know the answer to it now, and I'm not prepared to say that we want to have a large tax reduction on December 31 when I don't know that all the pieces of your scenario are right; I would have some doubts about it.

The problem is, how can we minimize the adverse signal that is implicit here and maximize the constructive signal; I think the whole thrust of the discussions over these months should be on that point. That's, in a sense, a summary of what I'm trying to say. Let's get together a program which does what we can do about productivity. It's a complicated, large problem, but one thing we're pretty sure we can do about it is work on the investment side. That's a good signal. What's the most effective way to do it with the minimum adverse repercussions elsewhere?

When you get into the personal tax reduction, while there are some general incentive effects which one could argue about any tax reduction marginal rates, the question is can we do better than that? Are there some ways we can directly or implicitly cut more effectively into this cost-wage price process? Again, one of the concerns that I have is, what happens if we sail along and say we're going to have a massive injection of purchasing power right now: we've got a recession; we're a little uncertain about the outlook; the risk is all on the side of too much unemployment, so we'll pump in the purchasing power? What kind of signal does that send in the wage bargaining and pricing policies? What kind of signal does it send to the foreign exchange market? What kind of signal does it send to the domestic bond markets? If it sends the signal to the domestic bond markets that this isn't the time to buy bonds, this is the time to sell, you get interest rates going up. You get the mortgage market congested; you won't get the recovery in housing; you will have the self-fulfilling prophecy of the housing remaining on the bottom. You will say, "What went wrong?" What went wrong is that that side of the equation wasn't taken into account.

Senator **Lugar**. Thank you very much.

The **Chairman**. Chairman Volcker, I don't want you to feel that Senator Garn and I are badgering you on asking for specific targets for monetary aggregate growth in 1981. We have a very definite reason for that. As you know, the committee is required—and the language of the law says the following: "The committee shall submit to its respective body a report containing its views and recommendations with respect to the Federal Reserve's intended policies." So we have to do that within a week or two after this hearing and we want to make a report that means something, not based on vague rhetoric but based on some kind of specific knowledge of where you intend to go.

Furthermore, there's an out for you, since we had this on the books and it's been taken advantage of consistently because the law says that nothing in this act shall be interpreted that it be required that the objectives and plans of the ranges of the growth or diminution of the monetary aggregates disclosed in this report be achieved if the Board of Governors and the Federal Open Market Committee determine they cannot or could not be achieved because of changing condition.

You talked about NOW accounts and the distortions that may be involved there. It would be perfectly understandable to me if you miss your target by a wide margin because of that development about which we have had no experience.

So, for that reason, I would hope that you would go back to your colleagues in the Open Market Committee this week and tell them the congressional concern about this issue and let us know by 1 week from today either your target ranges for the aggregates for 1981 or your legal defense as to why those targets are not being made to Congress as clearly required by law. At least that's my judgment and we would like your legal case before us so we have it here and we can consider it.

Mr. Volcker. I will just repeat that our legal counsel's clear reading of the law is that a numerical target is not required for next year.

The Chairman. We would like you to put that in writing and submit it.

Mr. Volcker. I would be glad to do that, and I would be glad to consult with my colleagues. I don't want to leave you with the impression that your persuasiveness, or my translation of your persuasiveness, is going to lead them to that kind of blinding light and they'll say suddenly, "Yes, we do want to put that in."

[The week subsequent to the hearing the following letter was received from Chairman Volcker:]

Federal Reserve System,
Washington, D.C., July 29, 1980.

Hon. William Proxmire,
Chairman, Committee on Banking, Housing, and Urban Affairs,
U.S. Senate, Washington, D.C.

Dear Chairman Proxmire: It is apparent to me from the questions and discussions at the recent monetary policy oversight hearing before your Committee that confusion has unfortunately arisen over the intent of the Federal Open Market Committee in characterizing monetary target ranges for 1981 only in general terms. I was, for instance, disturbed that some members of the Committee apparently seriously considered that the FOMC was somehow signaling a reluctance to provide specific numerical targets for 1981 at an appropriate time—a thought, I can confidently say, has never entered FOMC discussion.

Our concern was quite different. We wanted to reiterate, as clearly as possible, the intent of the FOMC "to seek reduced rates of monetary expansion over coming years, consistent with a return to price stability" and the "broad agreement in the Committee that it is appropriate to plan for some further progress in 1981 toward reduction of targeted ranges." We believed then, and believe now, that those general statements are the clearest and most useful indication of intentions that we can make (and are responsive to the requirements of Public Law 95-523, the Humphrey-

Hawkins Act) and we have been concerned that an attempt to set forth precise numerical ranges for each target could well prove to be ultimately a source of confusion rather than clarity. A major part of the reason is that certain institutional changes are in train or in prospect—in particular the introduction of NOW accounts on a nationwide basis but also the possible continued development of money market funds—that will upset "normal" relationships among the various aggregates and their relationship to economic activity. While we know these institutional changes are under way, the magnitude of their impact is (and for a time inevitably will remain) in substantial doubt. Moreover, the FOMC wished to appraise for a period of time the lasting significance, if any, of the recent short-fall in M-1 relative to economic activity.

Unfortunately, our attempt to cut through the institutional uncertainty to describe the broad substance of our intent with respect to monetary growth ranges seems to be subject to misinterpretation. To attempt to clear up any misunderstanding, let me indicate that, abstracting from the institutional influences and questions cited above, the general intent of the FOMC at this time can be summarized as looking toward a reduction in ranges for M-1A, M-1B, and M-2 for 1981 on the order of one-half percentage point. Converting that approach into specific numerical ranges for next year requires making a number of technical judgments that involve considerable uncertainty and necessarily, at this point, a degree of arbitrariness. Specific ranges for each aggregate, and assumptions behind their derivation, are shown in the attachment to this letter.

In accordance with usual procedures, all of the ranges will have to be reassessed in or before next February. The extent of downward adjustments in the ranges not only will be influenced by the various technical factors described in the attachment, but also will be conditioned by the speed with which inflationary biases in labor and product markets can be reduced, and by the likelihood that the economy can make an orderly adaptation to curtailed money growth. The need for public policies, other than monetary policy, to move in a complementary way to speed those adjustments was, of course, the essence of my testimony before the Committee.

The appropriate performance of money growth in 1981, within the ranges adopted, relative to actual results in 1980 will also depend to some extent on the outcome this year—on for instance, whether this year sees a very slow growth in narrow money because the public has, for one reason or another, economized sharply on cash balances.

The FOMC approaches the targeting process with a great deal of care, and is frankly concerned that changes in numerical targets, particularly once specified in detail as in the attachment to this letter, will give rise to confusion even when (perhaps particularly when!) such changes are purely in response to a technical, institutional change that has no real significance for monetary policy. But I trust this additional information will, despite those concerns, help further the greater public understanding of monetary policy that we both wish to foster.

Sincerely,

PAUL A. VOLCKER.

Attachment.

[Attachment]

DERIVATION OF SPECIFIC MONETARY GROWTH RANGES FOR 1981 ON THE BASIS OF CERTAIN ASSUMPTIONS

A number of technical judgments need to be made in deriving specific numerical monetary growth ranges for the aggregates in 1981 consistent with the intention to reduce ranges for M-1A, M-1B, and M-2 on the order of one-half percentage point. These include: (a) the extent to which the public will shift from demand deposits to NOW accounts next year; (b) the extent to which there will be shifts from savings accounts or other interest-bearing assets to NOW accounts; (c) the degree to which money market funds will continue their phenomenal growth (in the process drawing funds that would otherwise have flowed both through institutions whose liabilities are in M-2 and the open market); and (d) the extent to which the public will or will not tend to return to longer-run relationships between cash holdings, interest rates, and the nominal GNP—in other words, assessment of factors affecting shifts in the public's desire over the longer run to hold money balances in relation to income.

The degree of shifting into NOW and ATS accounts will depend on the aggressiveness with which banks and other depository institutions promote the new accounts, as well as on public response. Partly on the basis of experience in various New England States it may be estimated that in 1981 shifts from demand deposits to NOW accounts could lower M-1A growth by amounts ranging from 1 to 5 percentage points. Similarly, such shifts from savings accounts could raise M-1B growth one-half to 2½ percentage points.

If the mid-points of those ranges are taken as the best (but obviously crude) estimate available at the present time, target ranges for M-1A and M-1B would be implied of zero to 2½ percent and 5 to 7½ percent, respectively. In essence, those changes represent a one-half point reduction in the ranges adopted for 1980—which are 3½ to 6 percent for M-1A and 4 to 6½ percent for M-1B—but with the downward adjustment noted above for M-1A to allow for the effect of shifts into newly introduced NOW accounts from demand deposits and the upward adjustment for M-1B to allow for shifts from other assets. The target growth range for M-1A would have to be raised if shifts out of demand deposits were less than assumed, and lowered if shifts were greater. Similar reasoning would apply to the range for M-1B with regard to shifts out of savings deposits and other interest-bearing assets. The ranges for M-1A and M-1B also imply continued efforts in general by the public to economize on transactions-type cash balances.

Consistent with a reduction in ranges on the order of one-half percentage point, the growth range for M-2 for 1981 would be 5½ to 8½ percent unless money market funds, included in M-2, are judged to be drawing substantial new amounts of funds that in the past would have been lodged in open market instruments (which are not in M-2). Consistent with the indicated M-1 and M-2 targets, M-3 and bank credit ranges of growth for 1981 of 6½ to 9½ percent and 6 to 9 percent, respectively, could be the same as for 1980. Maintenance of these ranges relative to M-1 and M-2 is related to the growth in housing, business, and other credit that would be a normal accompaniment of the expected recovery in economic activity.

It should be emphasized that the relationship among the specific numerical ranges for the M-1s and M-2 are dependent at this state on necessarily rough, and somewhat arbitrary, judgments of the impact of institutional change and must be considered illustrative. These complications should not obscure the basic intent of achieving a modest further reduction in monetary growth rates next year, as the FOMC indicated earlier. That the range for M-1B next year will, in all likelihood, be higher than this year needs to be understood as no more than a technical adjustment to accommodate one-time shifts out of savings accounts in response to the introduction of NOW accounts on a nationwide basis. The reduction in M-1A is exaggerated downward for comparable reasons. The basic point is that these ranges, abstracting from such shifts, are expected to be lower than in the preceding year, and thus reflect a further curtailment of money growth.

The **Chairman**. As I indicated in my opening remarks, the Federal Reserve has had an uncanny ability to miss their targets, almost unbelievable.

AIMING FOR LOWER TARGETS

Mr. **Volcker**. One area of sensitivity is that we do not think it's very helpful to put down a target that we don't have that degree of commitment to. I'm talking about a numerical target now, where we have a reasonable assurance and confidence we can meet it.

What we have tried to say—and forget about the technical adjustment, particularly of M-1B—is that we are aiming for lower targets next year than this year. If a precise number were attached to that, I think it would be questionable as to what more information that would really bring you, considering the uncertainties.

The **Chairman**. Just give us what you can.

Senator **Riegle**. Mr. Chairman, would you just yield at that point so I can support that request. Your interpretation is correct and it is important if the committee is going to fulfill its function that the letter of the law be met. It's not a law that any of us in this room single-handedly wrote. It happens to be a matter of statute and if there's a legal argument to the contrary we ought to hear it. Failing that, I think there has to be a performance here and we've got to have that information.

The **Chairman**. Thank you very much. I appreciate that a great deal.

Mr. VOLCKER. I just want to repeat that there really wasn't much uncertainty in our legal interpretation of whether a numerical range was required or not.

The CHAIRMAN. Well, the legislative history is pretty clear though. The report on the bill said that the Federal Reserve would report its "numerical monetary target for a fixed calendar year rather than a constantly rolling 12-month period."

Mr. VOLCKER. That we do. That's been an improvement. We now announce those targets in February for the current year.

The CHAIRMAN. Let me continue. "The first Federal Reserve report in February would cover the current calendar year. The second report in July would cover the remainder of the year and the next calendar year."

Now let me ask about the futures markets. Your studies of financial futures undertaken following your testimony before this committee—and your letter on that was very helpful and I do share your concern about the recent change of events in which certain future exchanges have introduced new contracts [reading]. "And I fully agree with your conclusion that it would be appropriate to firmly fix in law authority whereby the Fed or the Treasury would have veto power over the introduction of new futures contracts and Treasury securities." I want that veto also to cover foreign exchange and I think you do too. I have two questions.

Do you think that the Board would support the addition of such provisions in the Federal Reserve Act—that is, the Fed and Treasury veto power—and shouldn't the authority also extend to continuation of existing contracts so as to protect further the integrity of Treasury securities and the dollar?

Mr. VOLCKER. In a technical sense, I can't speak for the Board because we haven't discussed that particular question. I think I would strongly suspect they would support that.

In a more general way, we have had general discussions of this problem in connection with your general bill on margin requirements and other matters. I think I can best categorize the attitude of the Board generally—and I suppose it's an attitude that I would share—as not being eager to get into this business. There would be a great many problems posed for us in getting into this business. We are not ready to say we would beg not to be in the business, if that really seemed the most reasonable approach in the end; that is, if for some reason the most natural locus—or by all odds the most natural locus—of some of those authorities were the Federal Reserve, I did not detect an attitude that would oppose that.

On this question of the kind of veto power over particular contracts, I would be very surprised if that's troublesome to the Board.

[The following letter was received for the record:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

July 18, 1980

The Honorable William Proxmire
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Proxmire:

I wanted to write to you and bring you up to date on the status of our studies--in cooperation with the Treasury, the SEC and the CFTC--of "financial futures" and related markets. While considerable progress has been made in these studies, I regret to say that our analysis and thinking has not yet proceeded to the point that will permit us to offer any firm legislative recommendations. Nevertheless, I believe the work to date has helped to shape our thinking in such a way that does permit us to be somewhat more concrete than was possible at the time of my testimony on S. 2704.

Broadly speaking, the work to date has proceeded along two related lines. First, for purposes of facilitating the analysis, the "financial" futures and related markets were divided into segments as follows: Treasury and related securities; foreign exchange; equity and related instruments; precious metals; and, other debt-like instruments including commercial paper and CD's. For each of these areas, preliminary working papers have been drafted which, for the underlying instrument and all derivative instruments and markets, describe the structure and operation of the various markets including their current regulatory apparatus. Among other things, this analysis is designed to provide us with better insights into the interrelationships among various segments of the markets for a given underlying asset as well as the relationships across markets for various types of financial assets.

At least in a preliminary form most of the background work referred to above has been completed. The second line of our overall inquiry has centered on a series of interviews conducted by the study group with representatives of various entities that have an interest in these markets. In all, some

30 interviews have been conducted in Washington, New York and Chicago. Those interviewed include representatives of the various exchanges, trade associations, domestic and foreign related banks, brokers and dealers, industrial market participants and insurance companies who are users of the various markets. These interviews were completed on July 14 but in some instances follow-up discussions may be required. Thus, the study group has not yet been able to fully digest and assimilate all of the information and impressions that emerged from that effort. Not surprisingly, however, I am told by my staff that the interviews revealed a wide range of attitudes as to the nature of the problems--if any--in these markets and as to what should be done about the problems. I also have the distinct impression that some if not most of the people from the various agencies involved in the process have come away from the work performed to date--including the interviews--with the attitude that the issues involved are even more complex than was anticipated at the outset.

In an organizational and timing sense, the work has also been made a bit more complicated by P.L. 96-276 which, as you know, requires that the CFTC, in consultations with other agencies including the Federal Reserve, submit a related report to the Congress by October 1, 1980. At this time, I understand that the CFTC report will concentrate largely--but not exclusively--on the recent silver situation. However, even if that study is limited to silver, there is the obvious potential for overlap.

For our part, and independently of these joint studies, we have been exploring what steps might be taken by the Federal Reserve (and other bank regulators) to help insure that we have better and more timely information at our disposal in regard to the behavior of banks in financing activity in these markets. Specifically, we are exploring modifications in our regular reports on bank lending with a view toward singling out categories of loans that may be associated with "speculative" activity in these markets. At the same time I have asked the bank examinations staff to look into what further changes in bank examination procedures could be made to assist in that process. I expect that effort will, in the near future, result in the submission to the Federal Financial Institutions Examination Council of new guidelines, procedures and instructions that will focus more attention on this area in the examination process.

As to the larger questions to which our study and S. 2704 are directed, there are a number of related issues that have emerged from our studies that are suggestive of the directions in which constructive changes in the operation of the markets and/or the regulation of the markets might be made. For example, it would appear that position limits might have a role to play in limiting speculation, although I would be the first to concede that the difficult problems of enforcing and administering such limits need more study, especially where there is a world-wide market for the asset or instrument in question. At the same time, and looked at in the context of efforts further to solidify the financial integrity of the markets and the exchanges, as well as deal with excessive speculation, efforts might be properly directed at issues relating to the amount, nature and form of margins. In either case, it seems to me that there is a clear need for improved coordination of rules among the exchanges and for the increased availability of information regarding activity and positions in the markets. I myself am now more inclined to the view that at least some steps are needed in all of these areas.

Having said that, I will also confess that there is an open question as to the best way to achieve the necessary changes once it is more definite what the changes should be. I am not, for example, persuaded that all such authority need be lodged in the first instance with a government instrumentality, particularly if some kind of firm standby or veto authority could be placed with a government agency or a public oversight body. The important thing, of course, is that the public interest is clearly and unequivocally represented. In the final analysis, however, I know you recognize that the question of where any such authority is placed is not independent of the decision as to precisely what new or additional authorities should be adopted, and whether financial futures are dealt with differently than the traditional commodity markets.

At least in a small way, the nature and complexities of the situation we are facing in these markets have been illustrated by the recent chain of events in which certain exchanges introduced new contracts in Treasury securities. Both the Federal Reserve and the Treasury were opposed to the introduction of these contracts and the CFTC, for its part, has attempted to bar trading in these new contracts. While this matter is still under judicial review and the outcome is not clear, the episode is troublesome. Indeed, at the very least, it suggests to me that it might be appropriate to firmly fix in law authority whereby the Federal Reserve or the Treasury would have veto power over the introduction of any new futures contracts in Treasury securities and perhaps in foreign exchange as well. Similar consideration should be given to the potential interests of the government--including the SEC--with respect to the emerging markets for futures on equities and indices comprised of equity securities.

We will continue our efforts to complete our study in the shortest possible time frame. However, because of the scope of the effort and the role that must be played by other agencies, I am a little hesitant to commit to a firm completion date at this time. We will, you can be sure, keep you fully apprised of the status of the effort.

Sincerely,

Paul A Volcker

The **Chairman**. OK. Now we have your interim report by the Board's staff on the credit restraint program and now that the credit restraints have been lifted I'd like to say these were a little late, but I'm sure they'll make interesting reading. I do have a question about the credit restraints as the authority to proceed with the credit controls was granted to the Board by the President.

Further, since Executive Order 12201 indicated that the authorization granted shall remain in effect for an indefinite period of time until revoked by the President, my question is, has the President revoked the authorization granted under the Credit Control Act or does the Federal Reserve still have such authority to use at its discretion?

Mr. **Volcker**. I have not looked at that order in detail. It's my understanding that it was revoked except to the extent necessary to permit, for a limited period of time, the ruling we made about creditors being able to change the terms of consumer credit transactions.

The **Chairman**. What was the period of time?

Mr. **Volcker**. The regulation permits those changes to be mailed to account holders through September 5, 1980, 60 days from the time of the regulation.

The **Chairman**. Will you give us that Presidential order so we can put it in the record?

Mr. **Volcker**. Yes. That is the only provision not removed entirely because it was needed to complete the orderly changes that were begun. That was the only purpose of keeping any aspect of it, as I understand it. If it's different I will inform you.

[Chairman Volcker subsequently submitted the following Executive order for inclusion in the record of the hearing:]

[Executive Order 12225 of July 3, 1980]

CREDIT CONTROL REVOCATION

By the authority vested in me as President of the United States of America by Sections 205 and 206 of the Credit Control Act (12 U.S.C. 1904, 1905), and for the purpose of phasing-out in an orderly fashion the credit controls authorized by Executive Order No. 12201, it is hereby ordered as follows:

1-101. Section 1-101 of Executive Order No. 12201 is amended effective July 28, 1980, to read as follows: "The Board of Governors of the Federal Reserve System is authorized to exercise authority under the Credit Control Act (12 U.S.C. 1901 *et seq.*) to establish uniform requirements for changes in terms in open-end credit accounts for consumer credit; provided however, such authorization is revoked as of October 31, 1980.".

1-102. The authorization granted by Section 1-102 of Executive Order No. 12201 is revoked as of August 11, 1980.

1-103. The authorizations granted by Sections 1-103 and 1-104 of Executive Order No. 12201 are revoked as of July 28, 1980.

1-104. Section 1-105 of Executive Order No. 12201 shall be amended, effective July 28, 1980, to read as follows: "For purposes of this Order 'consumer credit' and 'open-end credit' shall have such meaning as may be reasonably prescribed by the regulations of the Board of Governors of the Federal Reserve System.".

1-105. Section 1-106 of Executive Order No. 12201 is revoked.

JIMMY CARTER.

The White House, *July 3, 1980.*

RETURN TO THE GOLD STANDARD

The **Chairman**. It's a little hard for some of us to believe, but there are some prominent economists—more I understand recently than in the past—who favor a return to a gold standard and the Republican platform specifies and I quote, "One of the most urgent tasks in the period ahead will be the restoration of a dependable monetary standard." Governor Reagan has indicated he's leaning toward a return to a gold standard. What's your opinion about a return to the gold standard and what effect, in your judgment, would this have if we took that drastic step of discipline? Would it be an effective anti-inflation tool? Would it drive us toward another 1930's type of depression? Would it be wise in light of the fact that gold is so overwhelmingly produced by South Africa and the Soviet Union?

Mr. Volcker. I don't see any circumstances arising that would really make it feasible or desirable to go back to anything that could be called the full gold standard. I think you could have an argument in the evolution of time about a more structured international monetary system, but a system that relies wholly upon gold doesn't seem to me to be feasible for a number of reasons.

You mentioned the fact that we are going to have a monetary system for the Western World and this is, in a sense, not a decision of the United States alone. We are dealing in a particular commodity the supply of which is almost totally controlled by South Africa and Russia. It happens to be a metal that has been subject to enormous speculative influences, mostly up recently but sometimes down, and we have seen a lot of fluctuations in both directions.

In my own thinking, that approach was not practical in any time period I'm interested in.

The Chairman. Would it be feasible to adopt any other kind of commodity as a standard?

Mr. Volcker. In fact, the comment that I saw in the Republican platform—and I hate to get into a discussion of any political platform, Republican or Democrat, given my particular position—was the thought that we need a disciplined, stable currency; that is, an economy without inflation, as I recall the words. I agree with that sentiment entirely.

The Chairman. But you have no commodity in mind?

Mr. Volcker. That statement says we want to get rid of inflation. That statement as I recall says that we want to have a firm monetary standard. I agree with that. That means we shouldn't have any inflation. I haven't got any commodity I'm going to pull out of a hat and I'm not going to say we ought to tie the dollar to any particular commodity. I'd like to see it tied to the general stability of prices.

The Chairman. Well, my time is up, but let me just ask, what would be the consequence of our adopting a gold standard? Could you give us just a brief comment?

Mr. Volcker. I just don't know what that means in present circumstances.

The Chairman. We had it in this country for most of our history as you know.

Mr. Volcker. We had a gold standard up until 1971. It was a rather limited gold standard in the sense that we had convertibility into gold for foreign central banks, period.

The Chairman. I'm not talking about that. I'm talking about the gold standard we had up until 1933.

Mr. **Volcker**. The 1933 gold convertibility standard, domestically, would in its full implementation—and again there are compromises that can be made—tie a circulating medium in the United States to the price of gold. I can't argue that the price of gold is stable; it hasn't been very stable recently. I think the point has been made that it's gone up over a long sweep of years.

The **Chairman**. As you know, we fixed the price of gold. We pegged it.

Mr. **Volcker**. We pegged it in terms of the dollar. You can't peg gold in terms of the price of other commodities and the price of gold in the last 2 months has fluctuated 30 percent in terms of the price of the general price level. There's no magic way of saying the price of gold is fixed in terms of other commodities. The history of the gold standard was not one of price stability at any point in time. I think it is fair to say that there was not a secular increase in prices and that's important; that's very important. But there was a lot of fluctuation up and down while we were on the gold standard. The characteristic in that period was occasional periods of down and of up, and there wasn't any particular long-term trend.

The **Chairman**. My time is up. Senator Riegle.

Senator **Riegle**. Mr. Chairman, first of all, in my previous question I mentioned that there was a lot of dismal economic data before us at the present time. I didn't take the time to recite it all, but I would like to ask unanimous consent that that be inserted at the appropriate point in my earlier remarks so that it's there as a backdrop to this discussion.

The **Chairman**. Fine. [See p. 111.]

NEW ECONOMIC ERA

Senator **Riegle**. Chairman Volcker, the earlier discussion we had is really based on a belief of mine that we have moved into a new economic era that is quite different in several fundamental ways from the economic circumstances we faced even as recently as 5 or 10 years ago in terms of the emergence of the world market conditions on a different scale. I am thinking in terms of the obvious oil problem, the drain of close to $100 billion a year for foreign oil, the loss of productivity gains in the United States, and what has become almost an endemic inflation that's been hounding us and much of the rest of the world along with a stagflation condition that also is worldwide. To some extent it's different in some places than in others, but certainly not confined just to our borders.

We have moved into this new economic period and we really have a very serious situation on our hands. To negotiate our way out of it or to navigate our way out of it and select the right blend of public policy is extremely difficult. This is partly because of the traditional ways of looking at these problems which I don't think fit the new circumstances very well.

So the invitation earlier to invite you or for that matter the Board to offer us your best thinking on the kind of possible tax initiatives we might make was not made without some thought or in any way to try to be provocative.

Mr. **Volcker**. I understand.

Senator **Riegle**. In other words, it really is essential that we try to think together about the very sophisticated set of problems and try to craft responses that will be productive rather than counterproductive.

I would like you to give us some general idea as to the timing and the size and the content of possible tax cuts that you think would help meet the same goals that the Federal Reserve Board is after in terms of minimizing inflationary impact, stimulating productivity, and trying to get maybe the heavy industrial side of the economy back on a sounder footing.

I would hope that rather than sidestepping or viewing it as something outside a proper area of response, that perhaps we're at a point where it could be seen as something that would serve a constructive purpose. We should think along those lines so we don't find ourselves moving in opposite directions or getting on a collision course by inadvertence. Given the fact that we are in a difficult time it really makes sense to pool our thinking.

Mr. **Volcker**. I would only put one reservation on your comment, Senator Riegle. I have a great deal of sympathy with what you're saying and it's quite obviously not beyond our thought and consideration. We should all be concerned with these problems, and I will be testifying before both the Ways and Means Committee and the Finance Committee later this week.

My only reluctance would be to, in effect, put into the public forum by one device or another a Federal Reserve proposal. I don't think that's our function. It could be confusing and hinder the debate instead of helping the debate. We haven't got any constitutional responsibilities for tax policy.

To some extent we can do that informally and it's important to do it informally, but I don't want to lead us into what I don't think is a constructive debate by saying the Federal Reserve has a detailed program, which is peculiarly the Federal Reserve program, for every aspect of economic policy. We don't even have the competence in some areas.

Senator **Riegle**. Whether it's formally or informally, I think there's also another way to do this in terms of talking about ranges and the kinds of targeted help, particularly on the business side, that might relieve some of the capital formation problems that exist. Certainly the Federal Reserve has some awareness of that. There are ways to do this without putting it in a form that is contentious. I hope that between now and the time of your testimony later this week, the more pointed those thoughts are the more helpful they can be. It doesn't mean that people necessarily agree, but I think in working our way to an agreement they will help to the extent we really focus on this as precisely as we can.

I'm very much concerned as to how the unemployment factor gets cranked into the overall monetary policy decisions. It's obvious to me from what you have said today and other times that you see the Federal deficit as having a major bearing on the equation——

Mr. **Volcker**. And on the credit market.

Senator **Riegle**. It's obvious when the economy has been falling as sharply as it has and the unemployment rate has been rising sharply—and I speak now as a member of the Budget Committee here in the Senate—that we get caught in this double ratchet where expenses go up sharply for unemployment and food stamps and trade adjustment assistance and things of that kind that are the so-called stabilizers, and we also get the horrendous shortfalls of revenue. It's happening also in the States. If we don't find a way to stabilize the economy and get it on the upkick, we're going to be saddled with a burgeoning Federal deficit.

You now serve on the Chrysler Loan Guarantee Board, so you have had a chance to look at that specific industry's problem which is somewhat reflective of the larger problem of the auto industry. If you broaden it out into the broader industry, taking steel, and the whole reindustrialization issue that the country is beginning to understand and debate more—I think the extent to which you could help conceptualize and work through the debate on targeting and how much targeting might make sense——

Mr. Volcker. In the industrial area? You're not talking about the monetary area?

Senator Riegle. Essentially private business economy. If we're going to have something like a refundable tax credit or 10-5-3 or some other device that goes at the capital investment issue, we are probably at a point where we need to jump a level of sophistication and analysis on how that's likely to impact. A generalized approach would be the guy that builds the next McDonald's stand gets the same tax treatment as the guy thinking about building a complex steel factory gets. Those two things are different, given what we see as the capital issue and the question of other strategic factors not limited to defense factors, but economic factors in terms of the economic health of the country.

I would hope that somewhere we could start to see people coming forward to seize the initiative in defining these issues in less simple terms and more in terms of the complexity that is inherent within them so we can start making some pretty careful judgments as to how we aim at whatever it is we intend to do.

I know there was an effort made one night here late on the Senate floor to pass a 10-5-3 depreciation proposal that would apply to the auto industry and the steel industry, only to find later on that there are a number of companies in both industries that said that wouldn't help them because they are in a loss position. If you really want to target that kind of help you've got to do it on a refundable basis and then that raises some precedent setting issues that really deserve some care in addressing.

My appeal to you would be this: Our new economic problems are sophisticated and difficult to understand. The great danger is that we will apply a standard notion and standard rhetoric, especially in times of emergency, that could really be very far off the mark in terms of accomplishing what we need.

The time for action now is really quite good. The problems are real. There's consensus forming and we want to respond to them. But the Federal Reserve Board and yourselves are going to have to find some new ways to help focus the argument down to the kinds of specifics that would be compatible with other overall economic policies and strategies so we really come out ahead of the game. The chance to influence that debate is real even within the next month or so, if not within this week.

So my suggestion and invitation earlier was really meant in the form of an extraordinary appeal to you to see if maybe this is a time where we've got to go beyond the bounds of what has been normal practice, whether it be done informally or publicly in a formal way, to try to craft something that the country desperately needs right now and see that it's done properly.

COMMENTS IN RESPONSE

Mr. **Volcker**. If I may make just two very brief comments in response. The kind of malaise, combination of longer term problems that you referred to—I think is very real. I think the principal lesson to be drawn from those is that these short-term decisions that are made perhaps crucially in the next 6 or 8 months be taken with an eye toward how they fit into those long-range problems. Do they help or hurt in terms of that productivity problem and the inflation problem, the foreign competitive problem, and all the rest? You've got to look at the short-term decisions with respect to unemployment and inflation in that longer term context; I don't think we have done enough of that.

I think opinion is changing and there are better chances of doing that now. So as far as the industrial policy and aiming it at one sector or another is concern, you're getting into an area which is even further removed from the particular competence of the Federal Reserve, but I just want to leave you with at least a little note of skepticism that the record is not very good on the aim of governments in that respect, and I feel quite cautious myself in my ability or the Government's ability to pick the winners and losers and which industry really is one to be backed extraordinarily and which industry is not.

There are, I think, some rather rare exceptions to that when a national security problem or a question of survival is involved. The energy industry is a potential example. The market is sometimes pretty rough and ready, but I'm not sure we have a better mechanism for making some of those decisions.

Senator **Riegle**. I might just say that you and I both participated in the meetings with a number of our foreign friends from Germany and Japan and other industrialized nations who now are major economic rivals and forces to contend with, and they have found quite a different way to handle some of these transitional issues than we have. I'm not saying that we would want to copy what they do one for one, but I do think we have to find a way to match in effectiveness what some of our international rivals and friends have managed to accomplish. We're lagging in that respect and there's a point at which the national survival and security argument starts on military considerations and those are real. Some of these issues in terms of some of our basic industries, finally stretch across to the economic side. I don't want to see another run on the dollar. When I look at the comparative status of foreign currencies, since October 5 of last year where the dollar is down against the yen by 55 percent and the franc by 2.5 percent and the German mark by 1.3 percent, 8.1 percent against the British pound—I don't want to see us in a situation where suddenly we've got a mad scramble to cover the dollar, we have interest rates gyrating again and find ourselves with unemployment above 10 percent in the United States.

Mr. **Volcker**. I could not agree with you more.

Senator **Riegle**. Well, I would hope that we would—You say 6 or 8 months. I think it's more like 6 or 8 weeks. We are on a decision path partly because of the presidential politics and partly because of the nature and the timing the system works and the session of Congress.

Mr. **Volcker**. I don't mean delaying the debate. I think the debate is here.

The **Chairman**. I just have one final question, Mr. Chairman. You have been extremely patient. When you came up at the beginning of this period you thought we'd be here only a short time but as often happens the work fills the time available I guess.

It's a question that might interest Senator Riegle. You're a member of the Chrysler Loan Guarantee Board, which just approved another loan guarantee to Chrysler of up to $300 million.

The law requires the Board to determine that Chrysler can continue as a going concern—that it is viable over the long term—before providing any guarantees. I wonder how you were able to make this determination when the Board's own report, submitted to the Congress on July 15, shows that Chrysler's situation is getting worse and all indicators are down.

First, the U.S. automobile market is weakening and Chrysler's share of that market is far lower than predicted.

Second, Chrysler's losses in 1980 may run as high as $1.2 billion and I believe they were projected when we passed the bill at $473 million for 1980. They are now bigger than the 1979 losses.

Furthermore, the third point is that Chrysler is even having trouble selling its Omni and Horizon models, the front-wheel drive subcompacts that are supposed to be just what the present market demands.

Finally, Chrysler's own consultants, Booz Allen & Hamilton, are now for the first time seriously questioning the company's future viability. They say, "In summary, assuming a recovery in the market and in Chrysler's penetration, the present operating plan could give the company a reasonable prospect of viability. The risk of industry sales and pressure market sales of 1980 and 1981 are considerable." That's their own consultant.

Despite all these negative signs, the Board decided to approve this new loan guarantee. I judge you decided that Chrysler can make it because its new K car coming out this fall will sell like hotcakes and put the company in the black. But there will be strong competition from the GM X cars, and from new Ford and GM models coming on line, as well as from the imports.

What made you decide that Chrysler can make it and sell all those K cars when it can't even sell the Omnis and Horizons now?

Mr. **Volcker**. It was no lack of awareness on my part, and I suspect on the part of the other members of the board of the risks involved. I think we felt, and it's not an easy decision at this point, that it met the minimum statutory criteria. The future of that company, in my opinion, depends on how successful it is in its new models, particularly the K car. That is a test which is only a couple of months off. I'm not saying the test will be met conclusively in 2 months, but the test begins in 2 months. It is at that point that I think it no longer becomes a matter of weighing some risks, because we will get a little more conclusive evidence.

The CHAIRMAN. What you're telling us is you will make your decision based on whether the K cars really come through as projected, and you think that's the critical element?

CHRYSLER'S FUTURE

Mr. VOLCKER. I think, ultimately, the future of that company depends upon it.

The CHAIRMAN. How much more time do we need to make that decision?

Mr. VOLCKER. I think the formal introduction of the K car is early in October. You have some indication now—not conclusively, but some orders in advance—but I would think around the end of the year we will know where that car is going, maybe before if it performs exceptionally well; I think you're entering into a very crucial period for that company.

The CHAIRMAN. And you feel under the law that in the event the K car does not sell as well as projected or nearly as well as projected that you would then feel that you could make a judgment that the Chrysler Co. is not viable?

Mr. VOLCKER. I don't know what else is happening, but I think it would be very difficult in any circumstances like today's, if that car is not a successful product, it's its key product.

The CHAIRMAN. How do you explain the failure to sell Omnis and Horizons? They said their problem was only to produce enough, that they could sell everything they could produce. They're not doing that.

Mr. VOLCKER. I think that's due to the low point in the car market. There is some evidence of improvement; I don't want to put much weight on that, but the last few figures are a little better. In the depths of the market in May and June, the market for the Omni and the Horizon did weaken along with that of other small cars, including imports. Whether that's a 2-month phenomenon or not, we don't know.

The CHAIRMAN. Well, we'll be watching your judgment on that very carefully. Incidentally, I'm very glad that you're one of the three voting members of that Board, along with Mr. Staats.

Mr. VOLCKER. It's not been delightful, I must say.

The CHAIRMAN. I know you're very grateful to us for giving you that assignment.

Senator RIEGLE. Mr. Chairman, I might just add a comment, if you're finished, on this subject, and that is that I had a chance over the last week to see the new K cars out in Detroit and they are quite different as a matter of fact than the Omnis and Horizons in that they are larger, so they are more accommodating in terms of——

The CHAIRMAN. Larger?

Senator RIEGLE. They are both larger and they get better mileage, which is the ideal mix. So they are directly competitive with the kinds of cars that General Motors is now selling in what they call their X car line. So if one looks at the—I happened to look at the Omni and Horizon side by side with what was called the K cars, the new Chrysler cars, and I think they're going to be excellent cars.

I might say in terms of initial response, Chrysler now has 75,000 firm orders from fleet buyers. In fact, fleet buyers wanted to take more of the cars because they like to get them early in the run. They want to get them and get them on the run. Chrysler has decided that, because this car is so important to its dealer network to enable it to get well and healthy again, that they feel they can't afford to take more orders from fleet buyers because they're going to keep the remaining cars available to their dealer network to sell at retail to individual buyers.

I think if the economy shows any kind of upturn at all and God help us if it doesn't, it's not going to be just Chrysler in trouble—it's going to be a lot of people in trouble, both in and out of the automobile industry. But if the economy begins to come back, I think you will find that those cars will do quite well.

Mr. **VOLCKER**. The Chrysler Guarantee Board, I should say, has had consistently favorable reports about the K car. It's only now going into regular production, but we acted on the knowledge that the reports of production planning, styling, performance were all highly favorable.

Senator **RIEGLE**. Actually, they are ahead of schedule, I might also report. They are going to have the cars coming off the assembly line about 2 weeks ahead of schedule. Also in the area of fits and finishes in terms of that particular complaint that's been made against all American cars, there's been a new agreement reached between the United Auto Workers and Chrysler to change the quality procedures to make sure that the cars that come off the line meet the highest possible quality standards. So there's a lot of encouraging news actually.

The **CHAIRMAN**. That's true. Of course, they are also ahead of schedule on their losses—way ahead. My time is up.

Thank you very, very much, Mr. Chairman, for excellent responses.

The committee will stand adjourned.

[Whereupon, at 12:35 p.m., the hearing was adjourned.]

[Additional information received from the Federal Reserve Board follows:]

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 22, 1980

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Midyear Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

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CHAPTER 1

THE OUTLOOK FOR THE ECONOMY AND MONETARY POLICY OBJECTIVES

SECTION 1. THE OUTLOOK FOR THE ECONOMY

The economy moved into recession in the first half of this year. A cyclical downturn had been widely anticipated for some time, but the decline in spending, output, and employment, once under way, has been steeper than most analysts had foreseen. The second quarter decrease in real gross national product, at an annual rate of about 9 percent according to the Commerce Department's preliminary estimate, was considerably sharper than in the initial quarters of other postwar recessions.

The slump in activity has been most pronounced in the housing and auto industries—the latter sector being adversely affected by structural problems as well as by general cyclical pressures. But the decline has not been limited to these sectors. Retail sales excluding autos have dropped considerably since January, and business outlays for equipment and new construction also have fallen.

The very sharp curtailment of spending on houses and consumer goods and services in the current downturn probably is attributable in large part to the cumulative effect of inflation on consumers' financial well-being. Real disposable personal income was virtually flat in 1979 and has declined appreciably this year. Earlier, consumers had reduced their rate of saving in the face of shortfalls in real income in an effort to maintain consumption standards and in anticipation of inflation. This was accomplished by further rapid growth in installment and mortgage credit in the late stages of the recent expansion, but with the result that debt service burdens—which already were at high levels historically—continued to climb. Sharply higher interest rates and generally more stringent credit terms in late 1979 and early 1980 acted as additional deterrents to spending, encouraging households in their efforts to reduce debt and to rebuild savings.

The falloff in final sales has caused businessmen to spend more cautiously. This tendency has been reinforced by financial factors as well. The liquidity position of businesses had deteriorated appreciably during the expansion, particularly in the latter stages when there was a surge in short-term borrowing; many firms now are making strong efforts to restructure balance sheets.

The unexpected rapidity of the current downturn thus far has led analysts to reassess their view of the prospects for economic activity in the period ahead. Significant disagreement has arisen with regard to whether recovery will be prompt and strong, with the recent relaxation of credit market conditions encouraging a resumption of normal spending patterns, or whether the cyclical adjustment will be prolonged and the subsequent upturn possibly sluggish. The experience of the past year or so has demonstrated the hazards of forecasting, and the uncertainties at the present time clearly are substantial. Much will depend, for example, on the perceptions of businessmen about the longer-range prospects for demand and the attractiveness of investment, the response of consumers to the 1981 model-year automobiles, and the strength of the rebound in housing that may develop in the wake of the recent easing in mortgage market conditions.

There are signs that the contraction in some sectors may be nearing an end, but these are far from conclusive. Retail sales in June turned up slightly after four months of sharp decline; in the first ten days of July auto sales were at the strongest pace in three months. Housing starts and sales of new homes strengthened in the most recent months for which data are available.

In reflection of the prevailing uncertainties, there is a considerable range of views among the members of the Federal Open Market Committee regarding the movement of major economic variables over the remainder of the year. Most of the members believe that the recession probably will persist into the fourth quarter, with a cumulative net drop in real GNP less than that in the downslide of 1973-75. Although the decline should slow in the months ahead, employment may be cut back further, and the unemployment rate could rise beyond 8-1/2 percent by year-end. The increasing slack in labor markets and in industrial capacity utilization should at the same time help to moderate inflationary pressures.

The table below presents ranges for key economic variables that generally encompass the judgments of the individual FOMC members about the probable performance of the economy this year and in 1981.

	Actual	Projected	
	1979	1980	1981
Change from fourth quarter to fourth quarter, percent			
Nominal GNP	9.9	5 to 7-1/2	8-1/2 to 11-1/2
Real GNP	1.0	-5 to -2-1/2	1/2 to 3
Implicit GNP deflator	8.9	9 to 10	7-3/4 to 9-1/2
Average level in fourth quarter			
Unemployment Rate (percent)	5.9	8-1/2 to 9-1/4	8 to 9-1/4

The outlook for 1981 is especially uncertain at the current time. Economic and financial developments over the next six months should lay the groundwork for the recovery anticipated in 1981. But, in addition, any actions taken in the fiscal arena would have an impact on the path of recovery. The projections presented in the table, which do not assume a tax cut in the next year, indicate a turnaround in economic activity--although there is a considerable range of views concerning the potential strength of the recovery. On balance, the forecast is for a moderate rebound in real GNP, accompanied by some further slackening in the pace of inflation. Unemployment, however, is likely to remain high throughout the year.

Should there be a tax cut in 1981, the impact on economic performance will, of course, depend on its timing and composition. There is the distinct--and very troubling--possibility that a poorly designed tax reduction, or one not coupled with adequate restraint on the expenditure side, might give rise to added inflationary and financial pressures that would in time dissipate the beneficial short-term effects of the fiscal stimulus. Any indication that the Congress and the Administration were moving away from a commitment to rigorous fiscal discipline would run the risk of reinvigorating the inflationary expectations that have played such a major role in the economy's difficulties. The Committee thus feels it important that the question of a tax cut be approached cautiously; if a tax cut ultimately is enacted, it should be carefully structured to enhance the productive potential of our economy and to yield the greatest relief from cost and price pressures over the longer run.

SECTION 2. MONETARY POLICY OBJECTIVES

The task for monetary policy—and for stabilization policy generally—in the current circumstances obviously is a difficult one. Recession naturally summons forth calls for stimulus to aggregate demand. The prevailing high level of unemployment, and the exceptional weakness apparent in particular industries and sectors of our economy, certainly must be given careful consideration in the formulation of public policy. But caution must be exercised in the application of any broad countercyclical stimulus, especially in the present environment of persistent inflationary pressures. Indeed, there is no clearer lesson from the experience of the past decade and a half than that excessive stimulus is detrimental to the objective of achieving and sustaining noninflationary, balanced growth.

A primary and continuing goal of monetary policy must be to curb the accelerating inflationary cycle. It now appears that some progress is, beginning to be made in that direction. Price increases have slowed considerably from the pace of early in the year, in part reflecting some relief in the food and energy sectors, but also as a result of the drop in demand pressures. In addition, recent attitudinal surveys point to a reduction in inflationary expectations. The continuation of this trend in expectations will result in a greatly improved economic and financial environment, one more conducive to long-term growth. We already have witnessed one benefit of an easing of inflationary fears: a substantial decline in long-term interest rates from their highs earlier this year and a revitalization of the bond markets. The Federal Reserve's pursuit of a policy of monetary restraint—evidenced this year by a moderation of money growth—has been an important factor in this turn in expectations; a sustained commitment to the attainment of noninflationary rates of money and credit growth is essential if this progress is to be extended.

Despite the improvement that has occurred, however, inflationary forces are far from subdued. The past years have left a legacy of adverse cost trends that will not be reversed quickly. Moreover, more extreme inflationary expectations easily could be reignited. In establishing its plans for growth in the monetary aggregates, the Federal Reserve will continue to place high priority on reducing inflation, believing that this is essential to fostering a sound and sustained recovery. Over the long term, a reduction in the underlying rate of inflation is essential for a strong U.S. economy, for encouraging the saving we will need to finance adequate capital investment, and for maintaining the position of the dollar in international markets.

But it is clear also that if inflation is to be restrained without undue disruption of economic activity we cannot rely solely on monetary policies. For example, fiscal discipline is essential to ensure that excessive pressure is not placed on the financial and real resources of the economy. The structure of our tax system should be examined with an eye to the incentives it provides for productivity-expanding research and capital formation. And the full range of governmental policies should be reviewed to ensure that they do not add needlessly to costs and do not stunt innovation and competition.

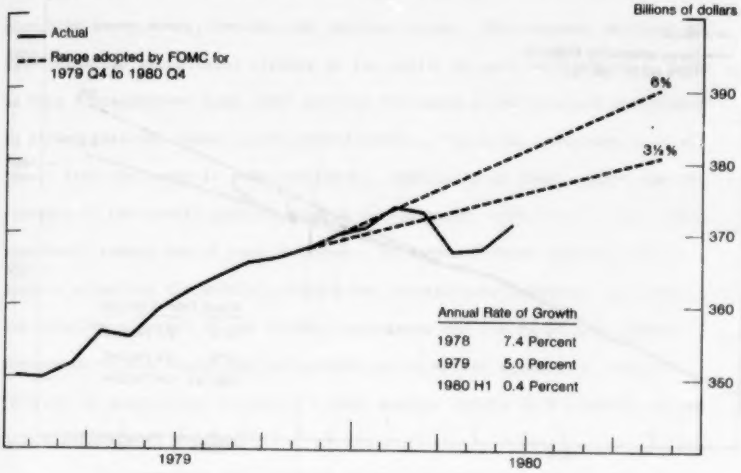
SECTION 3. MONEY AND CREDIT GROWTH IN 1980 AND 1981

In February the Federal Reserve reported to the Congress ranges of growth for the monetary aggregates in 1980 that it believed to be consistent with the continuing objective of reducing inflationary pressures over time while providing for sustainable growth in the nation's production of goods and services. These ranges anticipated a substantial deceleration in monetary growth in 1980 from the pace of the preceding year. Measured from the fourth quarter of 1979 to the fourth quarter of 1980, the ranges adopted were: for M-1A, 3-1/2 to 6 percent; for M-1B, 4 to 6-1/2 percent; for M-2, 6 to 9 percent; and for M-3, 6-1/2 to 9-1/2 percent. The associated range for bank credit expansion was 6 to 9 percent.

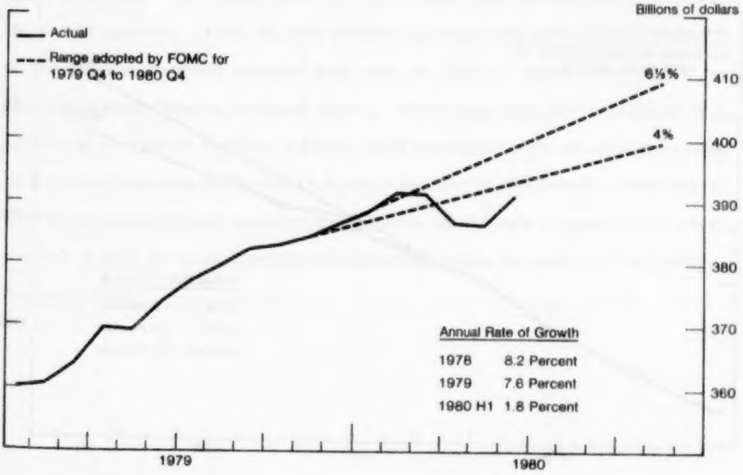
During the first half of 1980, growth of the monetary aggregates slowed considerably from the 1979 pace. The deceleration was particularly marked for the narrower aggregates, M-1A and M-1B, which grew at rates, below the lower limits of their longer-run ranges--at annual rates of about 1/2 and and 1-3/4 percent, respectively, from the fourth quarter of 1979 to the second quarter of 1980. (M-1A is currency and demand deposits held by the public, while M-1B includes checkable interest-bearing deposits as well.) At the same time, the broader aggregates, M-2 and M-3, grew at annual rates of 6-1/2 and 6-3/4 percent, respectively, which is somewhat above the lower limits of their ranges. In fact, by June, as the accompanying charts show, M-2--which includes money market fund shares and all deposits except large CDs at banks and thrift institutions--was around the midpoint of its longer-run range, and M-3 slightly below, while the narrower aggregates were moving back toward their ranges, following an unusually sharp drop in early spring.

Growth Ranges and Actual Monetary Growth

M-1A

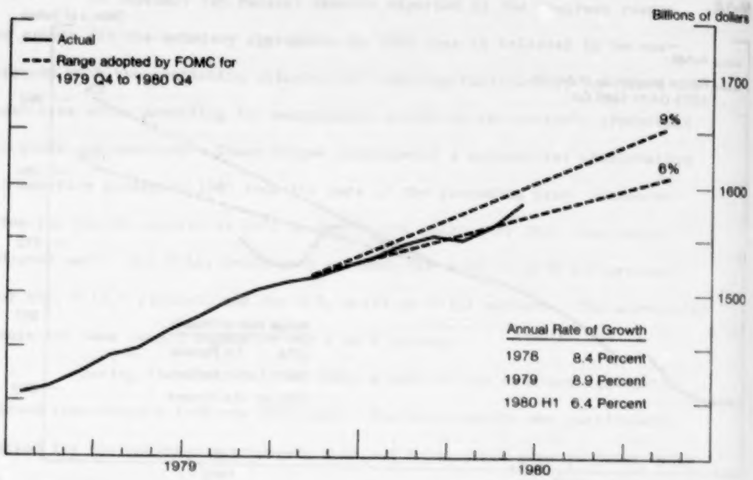


M-1B

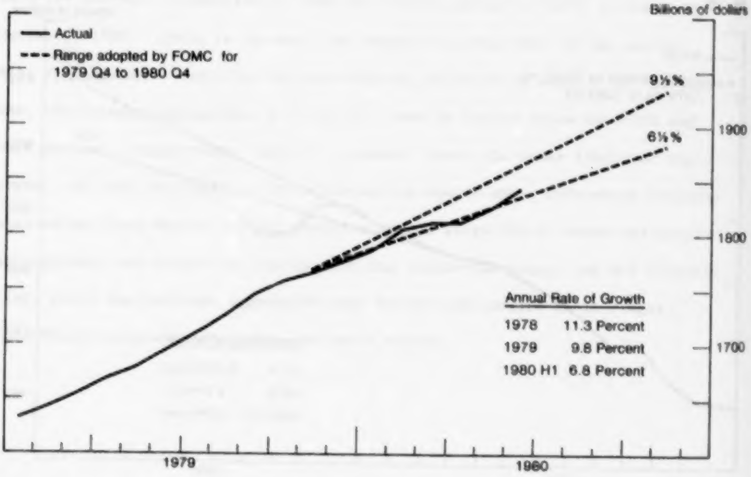


Growth Ranges and Actual Monetary Growth

M-2



M-3



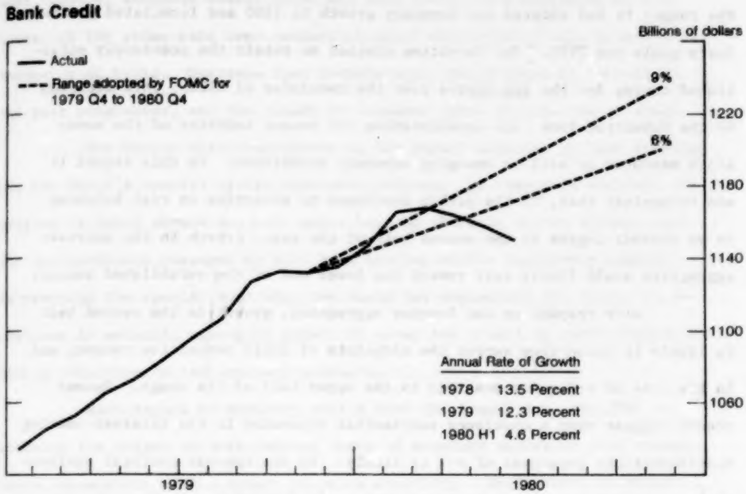
The contraction in the narrower aggregates during the second quarter was much greater than would be expected on the basis of the historical relationships among money, income, and interest rates. This unusual weakness may have reflected exceptional efforts by the public to pare cash balances, such as have characterized some other periods following a sharp upward adjustment in market interest rates to new record levels. There may also have been an impact from the surge in debt repayments, especially at banks, after the imposition of the credit control program in mid-March, with some of the funds apparently coming out of cash balances. In light of these special circumstances affecting the public's demand for transactions balances, and given the relative strength of the broader aggregates and the usual lags between changes in credit conditions and growth in the narrow aggregates, the FOMC believed it appropriate to foster a more gradual return of M-1 growth to the ranges established earlier.

In connection with reserve targeting procedures, System open market operations supplied a large volume of nonborrowed reserves over the course of the second quarter. Given the weak demand for money and bank credit, most of the added nonborrowed reserves were used by banks to repay borrowings from the Federal Reserve discount window. Borrowings fell from a high of $2.8 billion on average in March to minimal levels recently, and the easing of bank reserve positions was reflected in a sharp decline in the federal funds rate. From their peaks of late March or early April, short-term interest rates have declined 7 to 9 percentage points and long-term rates by roughly 2 to 3 percentage points.

Expansion in the broader aggregates over the first half of the yea reflected the very rapid growth for much of the time in money market mutual fund shares, 6 month money market certificates, and 2-1/2 year small saver certificates, instruments that pay market rates of interest. Late in the period, as short-term market interest rates declined sharply, the contractio in savings deposits at banks and other depository institutions halted, and the outstanding amount of those deposits began to rise. For part of the period, growth in M-3 was sustained also by continued issuance of large time deposits by commercial banks and thrift institutions, which are included in M-3 but not in M-2; however, large time deposits began to contract in late spring as credit demands weakened substantially.

Bank credit growth greatly exceeded the FOMC's range in the first quarter of the year. The second quarter, however, saw a sharp contraction in this measure, and credit growth was well below the FOMC-specified range as of midyear. Demands for bank loans by households and businesses dropped abruptly in the second quarter, while the banks—concerned about the possible erosion of profit margins by high cost funds obtained earlier and seeking to conform to the guidelines of the March 14 special credit restraint program--pursued relatively tight lending policies. Businesses, meanwhile, have met a substantial portion of their credit needs through issuance of commercial paper (which serves as a close substitute for bank credit for many large firms), by borrowing in bond markets, and by reducing holdings of liquid assets. Over the half year, the total of credit advanced by banks and in the private short-term money markets rose at an annual rate of around 7-1/2 percent.

Growth Ranges and Actual Bank Credit Growth



At its meeting in July, the Federal Open Market Committee reassessed the ranges it had adopted for monetary growth in 1980 and formulated preliminary goals for 1981. The Committee elected to retain the previously established ranges for the aggregates over the remainder of 1980. This decision by the Committee took into consideration the recent behavior of the money stock measures as well as emerging economic conditions. In this regard it was recognized that, if the public continues to economize on cash balances to an unusual degree in the second half of the year, growth in the narrower aggregates would likely fall toward the lower end of the established ranges.

With respect to the broader aggregates, growth in the second half is likely to place them nearer the midpoints of their respective ranges, and in the case of M-2 quite possibly in the upper half of its range. Recent trends suggest that a continued substantial expansion in the interest-bearing nontransactions component of M-2 is likely. In the current cyclical environment, consumers have begun to reevaluate their financial positions and have reduced their borrowing and adjusted upward their rate of saving. Thus, if the recent lower level of interest rates persists, the outlook is for an augmented flow of funds to depository institutions along with continued, though slower, growth in money market mutual funds.

The Committee also noted that the recent sharp contraction in bank credit makes it quite likely that this measure will fall below the 6 to 9 percent growth range specified in February. A resumption of bank credit expansion during the second half is anticipated, but the strength of that move will depend to a considerable extent on patterns of corporate finance. The desire for balance sheet restructuring may well continue to mute business loan demands, although weaker corporate cash flows and a narrowing of the spread of the prime rate over commercial paper rates likely will prompt some borrowing at banks. Mortgage loan demands also should begin to recover as the year progresses, and the runoff in consumer loans is expected to abate.

One factor that contributed to the recent weakness in bank lending was the Board's special credit restraint program. As announced earlier, the program is being phased out this month because there is now no evident need for extraordinary measures to hold bank lending within reasonable bounds. In removing the special controls, the Board has emphasized its intention to continue to maintain aggregate growth in money and credit at rates consistent with a reduction in inflationary pressures.

With regard to monetary policy over the longer run, the FOMC reiterates its intent to seek reduced rates of monetary expansion over coming years, consistent with a return to price stability. While there is broad agreement in the Committee that it is appropriate to plan for some further progress in 1981 toward reduction of the targeted ranges, most members believe it would be premature at this time to set forth precise ranges for each monetary aggregate for next year, given the uncertainty of the economic outlook and institutional changes affecting the relationships among the aggregates. The extent and timing of adjustments in the targets will depend upon an appraisal of the outlook at the end of the year. The appropriate money growth in 1981 relative to 1980 of course will depend to some extent on the outcome in this year--that is, on exactly where in the present ranges the various aggregates fall at year-end.

In addition, the various measures of money will be affected in 1981 by shifts in the demand for different types of financial assets. The introduction of NOW accounts on a nationwide basis in January will accelerate the shift from regular demand deposits into interest-earning transactions balances, thereby depressing M-1A growth next year. On the other hand, M-1B probably will be boosted somewhat next year by shifts from savings deposits and other interest-bearing assets into NOW accounts. The range for M-1B thus may have to accommodate a period of abnormal growth as the public adjusts to the availability of a new instrument. The experience of the past year and a half with ATS accounts has indicated the difficulty of estimating in advance the public's demand for such balances. Although growth in M-2 and M-3 will not be affected by NOW account movements, these broader aggregates include other relatively new financial instruments, the demand for which is still subject to uncertainty. The behavior of these instruments in coming months will aid the FOMC in determining appropriate growth ranges for the broader aggregates in the 1981 period.

SECTION 4. THE ADMINISTRATION'S SHORT-TERM ECONOMIC GOALS AND THE RELATIONSHIP OF FEDERAL RESERVE OBJECTIVES TO THESE GOALS

The Administration, in association with its midyear budget review has updated its forecast of the behavior of major economic variables for 1980 and 1981. The revised figures are shown below.

The Administration's Forecast

	1980	1981
Change from fourth quarter to fourth quarter, percent		
Nominal GNP	6-3/4	12-1/2
Real GNP	-3	2-1/2
Implicit price deflator	10	9-3/4
Average level in fourth quarter		
Unemployment rate (percent)	8-1/2	8-1/2

These estimates, which the Administration has indicated should be viewed as forecasts rather than as goals, show a considerably greater decline in real activity in 1980 than had been anticipated in the January Economic Report of the President. The outlook for nominal GNP growth through year-end has been lowered by a smaller amount, owing to a somewhat higher anticipated rate of inflation for the four quarters of 1980. The Administration's projections for this year fall within the ranges expected by the members of the FOMC.

The Administration has projected a resumption of output growth next year that places real GNP near the upper end of the range encompassed by the forecasts of the members of the FOMC. At the same time, the Administration's estimates place the rate of inflation somewhat above the range of the FOMC members' expectations. (Like the FOMC members' projections, the Administration's forecast does not include a tax cut provision for 1981.)

As indicated in the preceding section, the Federal Reserve intends to set monetary growth ranges for 1981 that will help to restrain inflationary pressures in the recovery period. As experience this year illustrates, considerable uncertainty attaches to any analysis of the relationships over relatively short periods among money, interest rates, and nominal GNP. However, a substantial expansion in demands for goods and services, accompanied by a lack of progress on the inflation front--or worse, an actual increase in inflation or inflationary expectations--would raise the possibility of a considerable firming of conditions in financial markets. Large and prolonged federal deficits would increase that risk. This highlights the urgency of concerted effort by the public and private sectors to reduce the rate of advance in costs and prices and the need to focus any discussions of fiscal action on approaches that would serve to alleviate cost pressures and bolster productivity.

CHAPTER 2

A REVIEW OF RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS

SECTION 1. ECONOMIC ACTIVITY DURING THE FIRST HALF OF 1980

Economic activity turned down early this year following almost five years of expansion. Between January and June, industrial production fell 7-1/2 percent, employment declined by about 1-1/4 million, and the unemployment rate jumped 1-1/2 percentage points. Real gross national product is estimated to have fallen at an annual rate of 9.1 percent in the second quarter, with the decline in activity widespread among major sectors of the economy. Retail sales have decreased substantially since January, housing starts have dropped to near-record postwar lows, and business outlays for equipment and new construction have declined. Although businesses were cautious in building inventories during the expansion, the severity of the recent decline in final sales has led to some involuntary stock accumulation; as in past cycles, the resulting efforts to curb inventory growth have played a significant role in the weakening of orders and production.

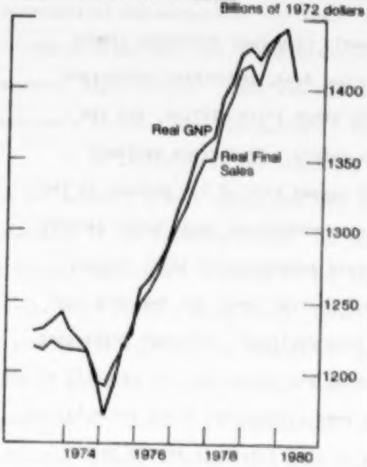
Recent reductions in aggregate demand, coupled with a slower rise of energy prices, meanwhile have brought some moderation in the overall pace of inflation. The producer and consumer price indexes have risen at much less rapid rates in the past few months than they did earlier in the year. Moreover, there are indications from consumer surveys that inflationary expectations have been lowered. Nevertheless, inflation still possesses a strong momentum, with unit labor costs continuing on a steep upward trend.

Personal Consumption Expenditures

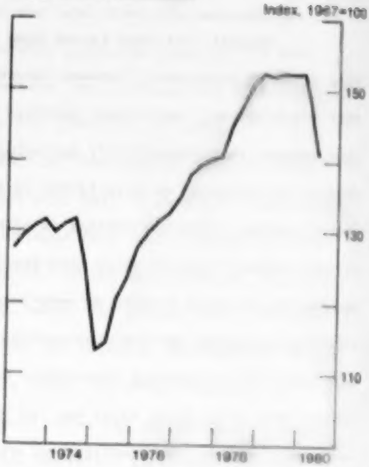
Personal consumption expenditures fell sharply in real terms during the first half. A number of adverse trends had characterized household finances for some time prior to the beginning of 1980. Real disposable income had stagnated after 1978, household liquidity positions had weakened as liabilities

Current Indicators of Economic Activity

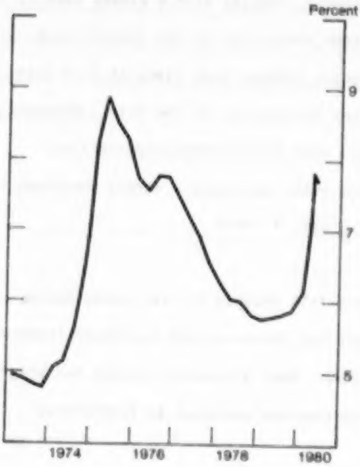
Real GNP and Final Sales



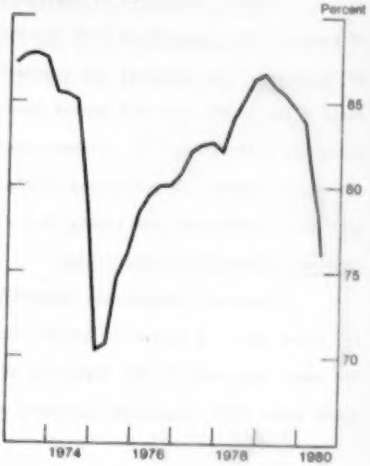
Industrial Production



Unemployment Rate



Capacity Utilization in Manufacturing

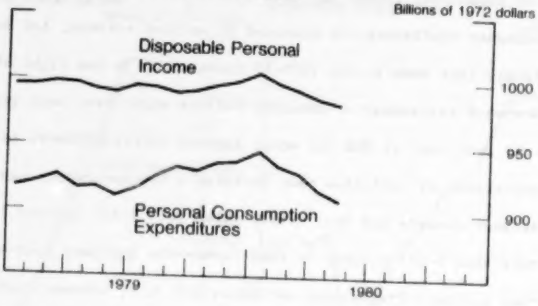


increased faster than financial assets after late 1976, and a near-record proportion of disposable income had been committed to the servicing of debt. Moreover, consumer confidence, as measured by opinion surveys, had deteriorated to levels last seen in the 1973-75 recession. In the light of these trends, a downward adjustment of consumer outlays might have been expected last year; the fact that it did not occur appears attributable in part to growing expectations of inflation that fostered a buy-in-advance psychology.

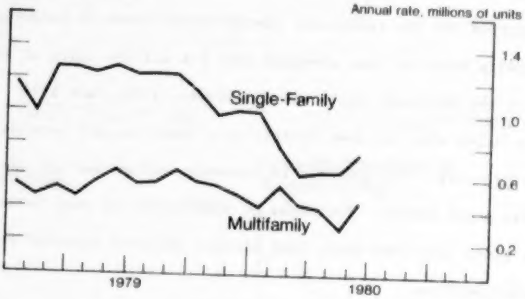
Between January and May, retail sales fell 6-1/2 percent in nominal terms and more than 9-1/2 percent in real terms--the sharpest four-month drop in the postwar period. Preliminary estimates for June, however, indicate that sales moved up somewhat. As in past recessions, large decreases in sales this year have occurred for the relatively discretionary items of consumer expenditure. Automobile sales in June averaged only 7.6 million units at an annual rate, close to the May pace, which was the slowest since late 1974. Furniture and appliance sales also are down sharply this year, in part because of the fall in housing sales. But weakness in consumer outlays has not been confined to the durable goods sector. Purchases of nondurables in real terms also have been falling since late last year, with sizable declines recorded for clothing and general merchandise.

Since January, real disposable income has decreased substantially as employment and hours worked have fallen and prices have continued upward at a rapid pace; nonetheless, the retrenchment by consumers has lifted the saving rate somewhat above the extraordinarily low level of the fourth quarter of last year. It still remains low by historical standards, however, and uncertainty

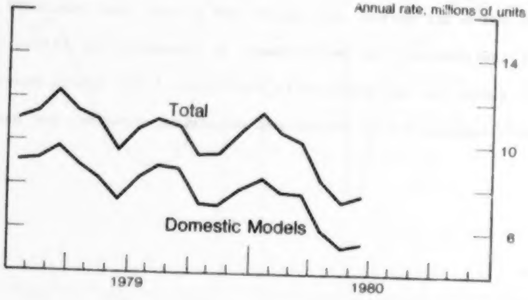
Real Personal Consumption Expenditures and Real Disposable Personal Income



Housing Starts



Auto Sales



about job and income prospects may well prompt households to enlarge precautionary savings, thereby contributing further to the weakness in personal consumption expenditures.

Residential Construction

Homebuilding activity has experienced a severe decline. Housing starts, which averaged nearly 1-3/4 million units at an annual rate during the first nine months of 1979, began to fall sharply last autumn. By December, starts were at a 1-1/2 million unit pace, and by May they had declined almost to a 900,000 rate. June saw a pickup in starts to a 1-1/4 million annual rate.

In the single-family sector, starts dropped 45 percent between the third quarter of 1979 and the second quarter of this year. Although demographic factors remained quite favorable during this period, the demand for such dwellings was curtailed by the increased cost of homeownership associated with higher house prices and the rapid rise in mortgage interest rates. The monthly cost of interest and principal on an average-priced new home financed with a conventional mortgage rose to $700 in May--a third higher than six months earlier and 50 percent above the same month of 1979. Households probably were increasingly reluctant to undertake such heavy financial obligations, especially as income and employment conditions weakened this year.

Home sales have dropped almost 40 percent from the pace of last summer. Although production adjustments have reduced the number of unsold new single-family dwellings on the market, these unsold units bulk larger relative to the recent slower rate of sales. At the May sales pace, which was up sharply from April, there was almost a nine-month supply of unsold new single-family units on the market. The pickup in sales in May is perhaps a sign of some increased interest on the part of homebuyers, prompted by the recent easing in financial markets; however, the still large overhang of unsold homes is likely to discourage a quick resumption of building in many localities.

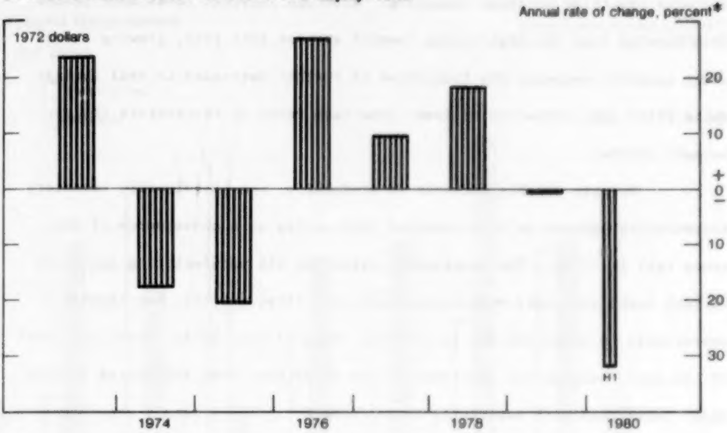
Multifamily housing starts began declining sharply late last year and in the second quarter were off about 35 percent from the already-reduced pace of the third quarter of 1979. The decline in this sector has been less severe than in the 1973-75 period, as low vacancy rates in many areas and an acceleration in rent increases beginning in late 1979 have given builders an incentive to sustain a significant level of apartment construction in the face of high construction costs and tight financial conditions. In addition, demands for condominiums--a lower-cost alternative to single-family homeownership--have provided support to multiunit activity.

Business Spending

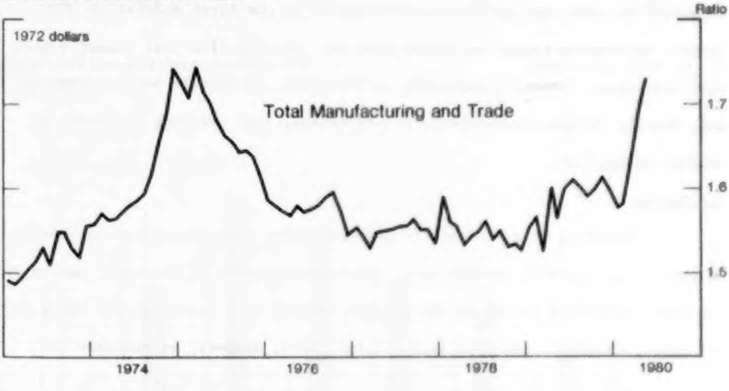
Business spending on plant and equipment has slowed in recent months as firms have sought to avoid expanding capacity at the onset of a recession. Spending on nonresidential structures, which accounted for much of the gain in investment during 1979, peaked in January and declined substantially in the following months. Business purchases of trucks and automobiles also have been falling since early this year, as have outlays for other capital equipment.

Weakness in capital spending in the first half of the year--as well as in forward-looking indicators of investment activity such as surveys, construction contracts, and equipment orders--probably reflected businessmen's anticipations that sales may remain sluggish for a while. In addition, corporate cash flows are diminishing, and with liquidity positions already

Contracts and Orders for Plant and Equipment



Inventories Relative to Sales



*Annual changes are from Q4 to Q4; semi-annual change is from Q4 to the April-May average.

strained in many instances, there may be a reluctance to undertake additional projects requiring external financing. Although interest rates have fallen dramatically from the high levels reached earlier this year, growing excess plant capacity suggests the likelihood of further decreases in real outlays, while firms take advantage of lower long-term rates to restructure their balance sheets.

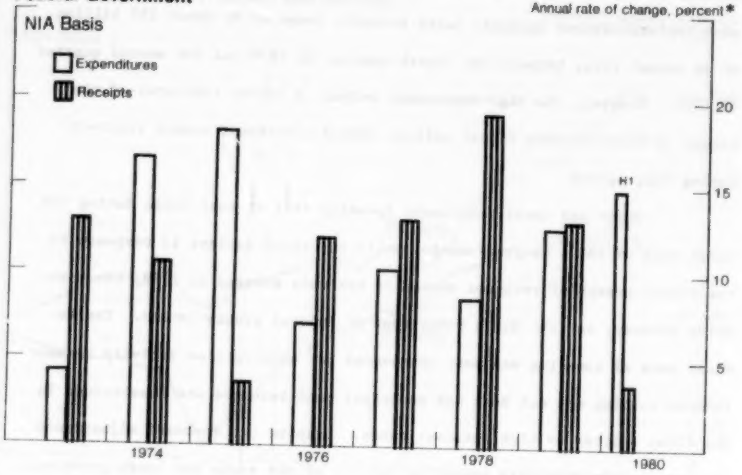
Despite sizable cutbacks in production, some involuntary inventory accumulation appears to have occurred this spring as a consequence of the steep fall in sales. The stock-sales ratio for all manufacturing and trade in real terms rose only moderately during the first quarter, but climbed appreciably in April and May to near the level of late 1974. Since the start of the year, substantial increases in the ratio have been registered in most major industries with especially large rises for primary metals manufacturers, furniture and appliance retailers, and the motor vehicle industry. Auto sales incentive programs and production adjustments in the first quarter of 1980 largely eliminated excessive stocks that had resulted from last summer's gasoline shortages. However, beginning in mid-April, automobile sales plummeted and, despite further curtailments of production, some overhang of stocks at dealers reappeared.

Government

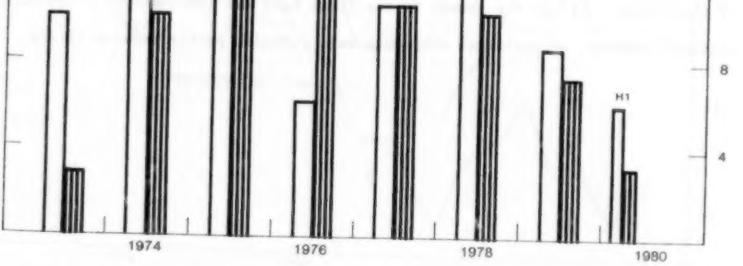
Spending at all levels of government has been restrained in recent months. Total federal expenditures, which grew rapidly in the early months of the year, moderated in the second quarter largely as a result of the March budget cuts. Growth in receipts fell off much more, however, as weakness in

Public Sector Expenditures and Receipts

Federal Government



State and Local Governments



*Annual changes are from Q4 to Q4; semi-annual changes are from Q4 to Q2.

Data for 1980 H1 are partially estimated by the Federal Reserve.

personal income and profits offset the impact of additional revenue from the windfall profits tax on oil producers. As a result, the federal deficit on a national income accounts basis probably deepened by about $30 billion, at an annual rate, between the fourth quarter of 1979 and the second quarter of 1980. However, the high-employment budget, a better indicator of the thrust of discretionary fiscal policy, showed a movement toward restraint during this period.

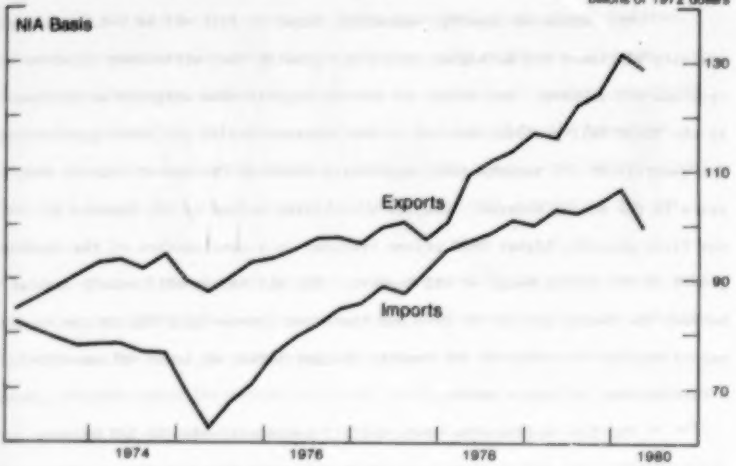
State and local government spending fell in real terms during the first half of 1980, as governmental units curtailed outlays in response to the slower growth of revenues caused by tax cuts enacted in 1979, the weakening economy, and the March reductions of federal grants-in-aid. The reduced pace of spending was most pronounced for construction activity because federal funding was cut back and municipal bond issuance was constrained in the first quarter by high interest rates. Despite the downward adjustments of outlays, the aggregate operating deficit of the state and local government sector apparently widened considerably in the spring.

International Trade and Payments

Real exports of goods and services continued to grow rapidly in the first quarter of 1980, but the rise appears to have slowed somewhat in the second quarter. The deceleration largely reflected the slowing of economic expansion abroad and the fading of the impact of the 1977-78 real depreciation of the dollar. All of the growth in the first half was concentrated in nonagricultural exports; agricultural shipments were reduced, partly because of the

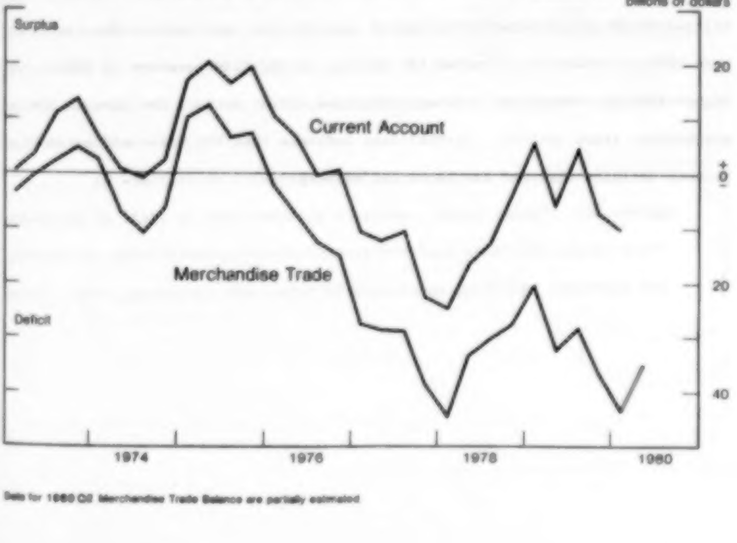
Exports and Imports of Goods and Services

Seasonally adjusted, annual rate, billions of 1972 dollars



Trade and Current Account Balances

Seasonally adjusted, annual rate, billions of dollars



Data for 1980:Q2 Merchandise Trade Balance are partially estimated.

embargo on additional grain sales to the Soviet Union imposed by the President in January.

The volume of imports, meanwhile, began to fall off as U.S. economic activity slackened and as higher prices and greater fuel efficiency acted to restrain oil imports. The volume of non-oil imports rose slightly on balance in the first half of 1980, but all of the increase was in the first quarter. The quantity of oil imports fell, apparently reaching its lowest rate in four years in the second quarter. Despite a declining volume of oil imports in the first quarter, higher OPEC prices resulted in a continuation of the rapid growth in the dollar value of oil imports. The oil import bill nearly doubled between the fourth quarter of 1978 and the first quarter of 1980; in the second quarter the value of oil imports changed little as lower volume offset a further rise in import prices.

The U.S. merchandise trade deficit increased about $6-1/2 billion, at an annual rate, in the first quarter of this year from the rate in the last quarter of 1979. The current account moved from a deficit of about $7 billion at an annual rate in the fourth quarter, and near balance for the year 1979, to a deficit of about $10 billion in the first quarter of 1980. Higher foreign earnings of U.S. oil companies offset part of the rise in the merchandise trade deficit. Partial data indicate that the trade and current-account deficits narrowed in the second quarter.

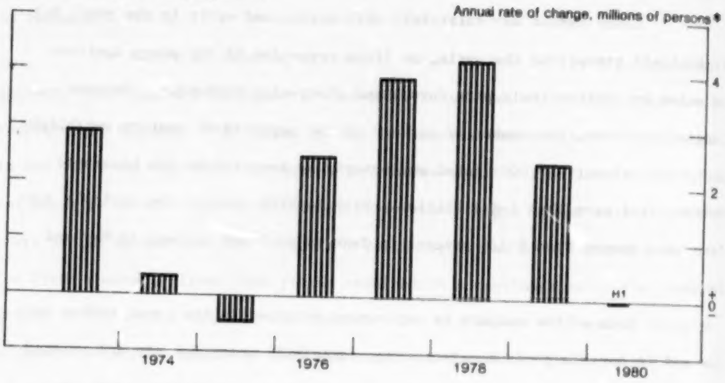
SECTION 2. LABOR MARKETS AND CAPACITY UTILIZATION

Labor demand was relatively well-maintained early in the year, but it fell off steeply in the spring as firms responded to the sharp declines in sales by cutting their work forces and shortening workweeks. Between January and June, the number of workers on the payrolls of nonfarm establishments fell almost 950,000; total employment, as measured by the household survey, fell more than 1-1/4 million. With layoffs rising, the nation's jobless rate jumped from 6-1/4 percent in January to 7-3/4 percent in May and June.

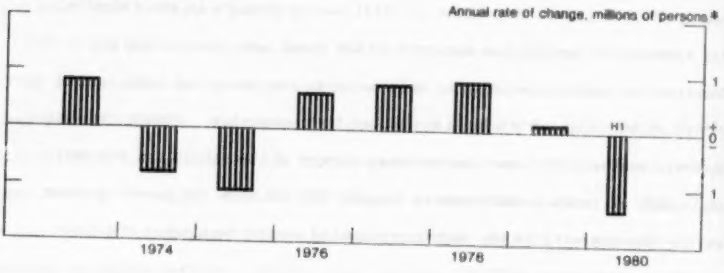
Much of the cutback in employment occurred in the construction sector and in durable goods manufacturing, especially motor vehicle and related industries. By June, the number of auto workers on indefinite layoff was nearly 250,000 (about 30 percent of total hourly workers in the industry), and substantial layoffs had occurred in the steel and tire industries as well. Construction employment began to drop early in the year, and subsequently suppliers of building materials also reduced their payrolls. During the spring, however, weakness in labor demand began to spread throughout the economy; employment at trade establishments dropped 190,000 over the second quarter, and in June payrolls in the service-producing sector registered the first monthly decline since 1975.

In addition to trimming payrolls, employers have curtailed work schedules in light of the weakening of sales. Since January, the average workweek at manufacturing establishments has been shortened almost 1-1/4 hours. More generally, the number of workers on part-time schedules for

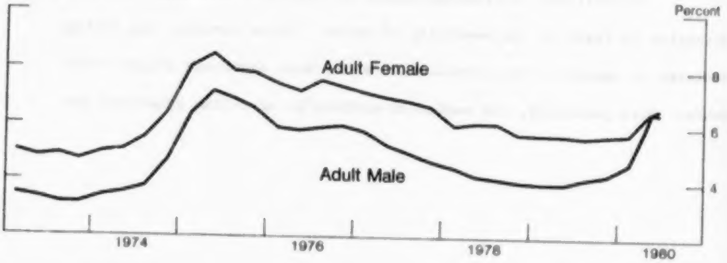
Nonfarm Payroll Employment



Manufacturing Employment



Unemployment Rates



*Annual changes are from Q4 to Q4; semi-annual changes are from Q4 to Q2.

economic reasons rose sharply in the second quarter, with former full-time jobholders accounting for most of the increase.

The rise in joblessness has been widespread among demographic and occupational groups, with especially large increases reported among adult males. Since December, the jobless rate among men has climbed almost 2-1/2 percentage points, compared with an increase of 3/4 percentage point for adult women, and June marked the first time in two decades that the rate for men was higher than that for women. Unemployment among blue-collar workers rose sharply to an 11-1/2 percent rate in June, the highest since September 1975. In contrast, unemployment rates among white-collar workers have increased only marginally since the end of 1979.

The adjustments in output by firms, especially in the second quarter, were reflected in a sharp decline in the index of industrial production. Between January and June, industrial production fell nearly 7-1/2 percent. Production declines in auto-related industries and in industries supplying construction materials began early in the year, but by late spring cutbacks were occurring in most other industries as well. Among manufacturing firms, capacity utilization in June dropped to 76 percent, almost 11 percentage points below its 1979 peak.

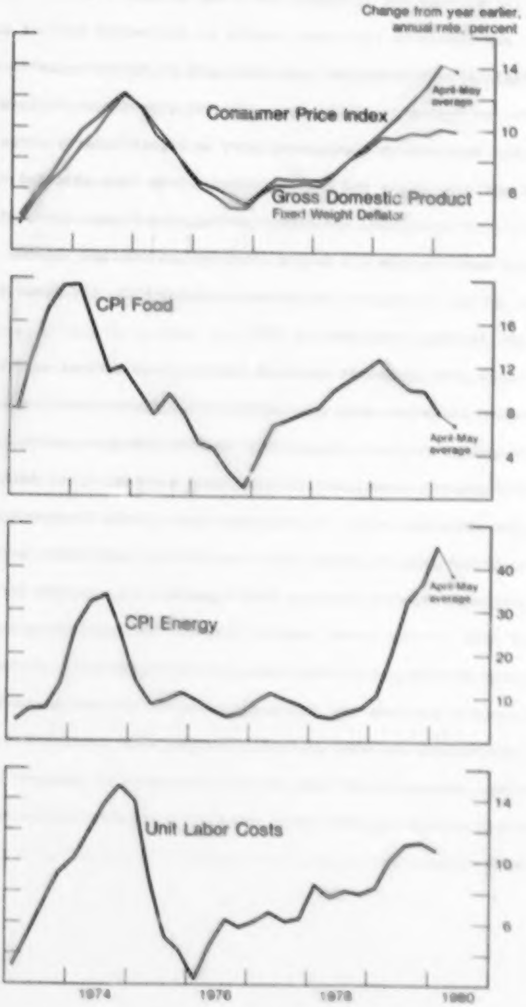
SECTION 3. PRICES, WAGES AND PRODUCTIVITY

After exploding upward in the early months of the year, rates of price increase moderated significantly in the second quarter. The improvement resulted primarily from a stabilizing of energy prices and from declines in the prices of nonferrous metals, after a flurry of speculative activity earlier in the year. Increases in the prices of construction materials and components also slowed noticeably in the second quarter with the decline in activity in the housing sector.

In the energy area, retail prices surged in January and February, in large part the result of the hike in OPEC prices that occurred in late 1979, but the pace of increase then slowed noticeably in the spring, as inventories reached near-record levels and demand continued to drop. The increase in energy prices also moderated at the producer level. Nonetheless, indirect effects of earlier increases in the prices of fuels and petroleum feedstocks were still evident through the end of June in items such as plastics and rubber products, industrial chemicals, and household supplies. Moreover, a number of factors--including the latest increases in OPEC prices, the curtailment of gasoline production, and the progressive decontrol of crude oil prices--suggest that further relief in the energy area is not to be expected.

Food prices generally have exerted a moderating influence on aggregate price measures since the beginning of the year. At the producer level, finished food prices fell at about a 4-1/2 percent annual rate between December and June. Steep drops in wholesale prices through May--particularly for livestock--alleviated cost pressures at the retail level, contributing to relatively

Prices and Labor Costs



stable retail food prices since the end of last year. However, recent developments in the markets for livestock and fresh produce indicate that food prices also are likely to rise more rapidly in the second half of the year.

Inflationary pressures have persisted in sectors outside food and energy since the beginning of the year. In the consumer price index, increases in the homeownership component have been particularly large, as the measures of mortgage rates and home purchase prices both advanced rapidly in the first half of this year; the recent easing of mortgage rates will likely hold down increases in the CPI during the next few months. In the producer price index, prices of capital equipment accelerated in the first half of 1980 from the already rapid pace of 1979.

Labor cost pressures remained intense in the first half of 1980, as compensation increases were substantial while productivity declined further. Output per hour in the private nonfarm business sector dropped at about a 1-1/2 percent annual rate in the first quarter, after falling 2 percent over the preceding year. At the same time, hourly compensation accelerated to a 10-1/4 percent annual rate, so that the unit labor costs of nonfarm businesses rose at about an 11-3/4 percent rate in the first quarter. Preliminary data for the second quarter suggest that unit labor costs continued to rise rapidly, as productivity contracted further. Although cyclical reductions in overtime and the changing employment mix may restrain the growth in total compensation somewhat in coming months, wage demands are likely to remain strong, especially in light of past increases in consumer prices. Thus, upward pressures on unit labor costs will probably remain substantial over the near term.

SECTION 4. FINANCIAL DEVELOPMENTS DURING THE FIRST HALF OF 1980

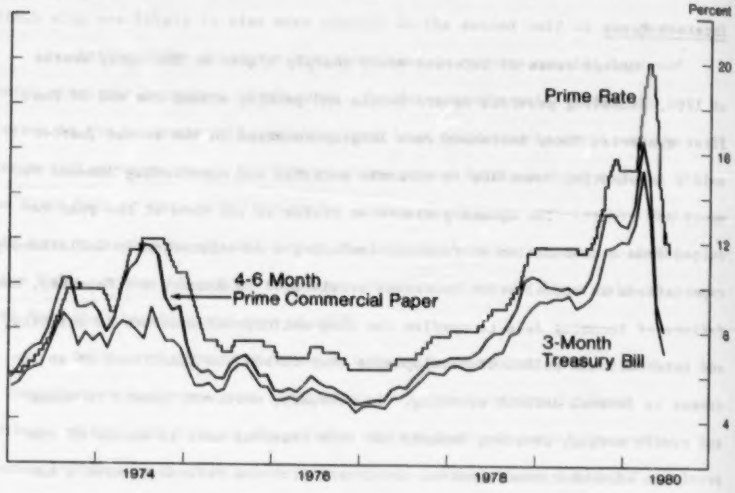
Interest Rates

Market rates of interest moved sharply higher in the early months of 1980, exceeding previous record levels and peaking around the end of the first quarter. These increases were largely reversed in the second quarter amid a substantial downslide in economic activity and contracting demands for money and credit. The upward pressure on yields at the turn of the year resulted from a combination of factors, including a deterioration in inflationary expectations as actual price increases accelerated in January and February, the failure of incoming data to confirm the long-anticipated downturn in activity, and international political developments that raised the likelihood of an increase in federal deficit spending. In February, moreover, growth in money and credit surged, creating demands for bank reserves well in excess of the provision of nonborrowed reserves consistent with the Federal Reserve's target ranges for growth in the monetary aggregates. In the Treasury bill market, in particular, the resulting rise in short-term interest rates was reinforced by large sales of securities by foreign institutions to finance intervention in foreign exchange markets.

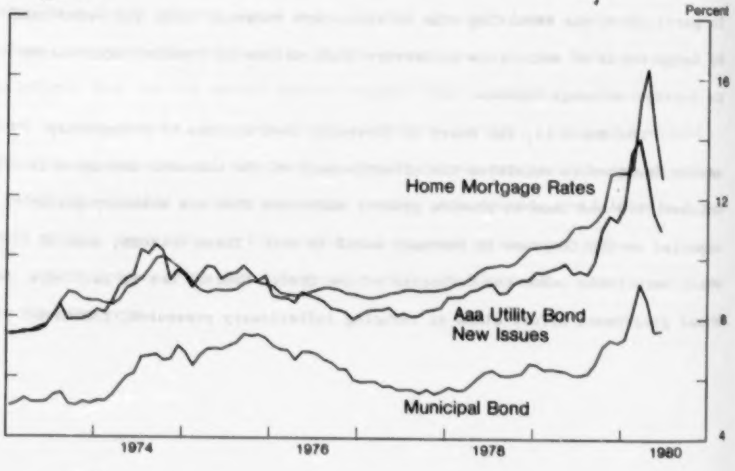
On March 14, the Board of Governors took actions of a temporary nature designed to reinforce the effectiveness of the measures announced in October 1979 and thus to provide greater assurance that the monetary goals reported to the Congress in February would be met. These actions, some of which were taken under the authority of the Credit Control Act as part of a broad government effort aimed at reducing inflationary pressures, included:

Interest Rates

Short-term



Long-term



(1) a special credit restraint program directed toward limiting the growth in loans to U.S. customers by commercial banks and finance companies to ranges consistent with the monetary and credit objectives of the Federal Reserve; (2) a special deposit requirement for all types of lenders on increases in certain categories of consumer credit; (3) an increase in the marginal reserve requirement on managed liabilities of large member banks and U.S. branches and agencies of large foreign banks; (4) a special deposit requirement on increases in managed liabilities of large nonmember banks; (5) a special deposit requirement on increases in total assets of money market mutual funds; (6) a surcharge of 3 percentage points on frequent borrowing by large member banks from Federal Reserve Banks.

These measures hastened the movement toward reduced credit availability already in train at many lenders, and apparently increased the resolve of consumers to curtail their use of credit. In subsequent weeks, incoming data revealed a substantial slackening in money and credit growth to well within the Federal Reserve's objectives. In light of these developments, the Board amended the special credit program: on May 6 the 3 percentage point surcharge on discount borrowing by large banks was eliminated, and on May 22 special deposit requirements were reduced by half and the special credit restraint guidelines were modified. On July 3 the final phase-out of the program was announced.

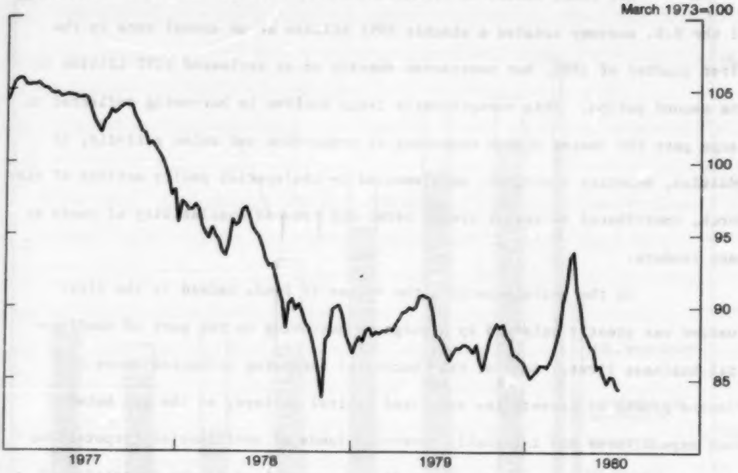
The rise in most interest rates came to a halt in late March and early April, and yields began to move down as demands for money and credit dropped abruptly in response to developing slack in the economy. Most private short-term rates fell 7 to 9 percentage points, to their lowest levels since the spring of 1978. In long-term securities markets, bond yields retraced most or all of the increases recorded earlier in the year, as market participants appear to have lowered their expectations of inflation. The restraining posture of monetary and fiscal policy, as well as moderating rates of price increase in the cyclical downturn, has contributed to this improved outlook for price changes.

Foreign Exchange Markets and the Dollar

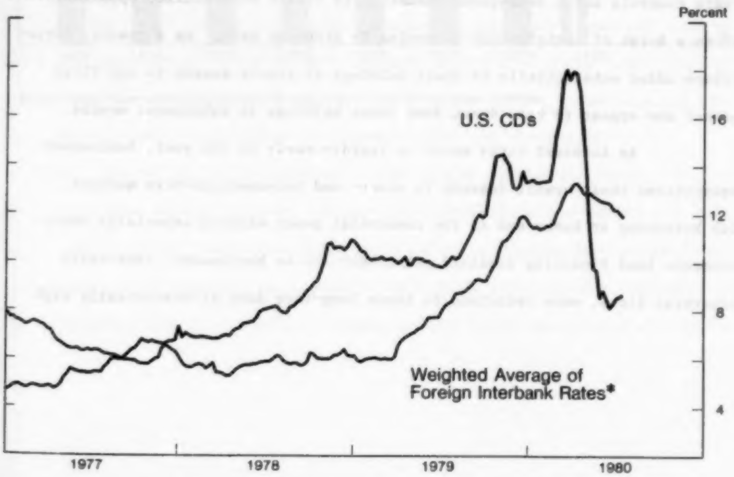
Movements in U.S. interest rates greatly influenced fluctuations in the foreign exchange value of the dollar over the first half of 1980. The dollar was in strong demand early in the year when U.S. interest rates rose sharply. The growing perception by market participants of accelerating inflation and worsening payments deficits abroad gave added impetus to the dollar's rise over this period, as did the announcement of credit control measures on March 14. Authorities in a number of foreign countries also moved to tighten monetary conditions, but the resulting increase in foreign interest rates lagged well behind that of U.S. rates. The strengthening in the foreign exchange value of the dollar in February and March was moderated somewhat by substantial intervention activities by U.S. and foreign monetary authorities.

The peaking and subsequent steep decline in U.S. interest rates in early April triggered heavy selling pressure on the dollar in international markets, and its foreign exchange value fell in the April to June period. Foreign and U.S. monetary authorities intervened to moderate this decline by making net purchases of dollars. Even so, by the end of June earlier gains were entirely erased, and the weighted-average exchange value of the dollar at mid-year was little changed from its value at the beginning of the year.

Weighted Average Exchange Value of U.S. Dollar*



3-Month Interest Rates



* Weighted average against or of G-10 countries plus Switzerland using total 1972-78 average trade of these countries.

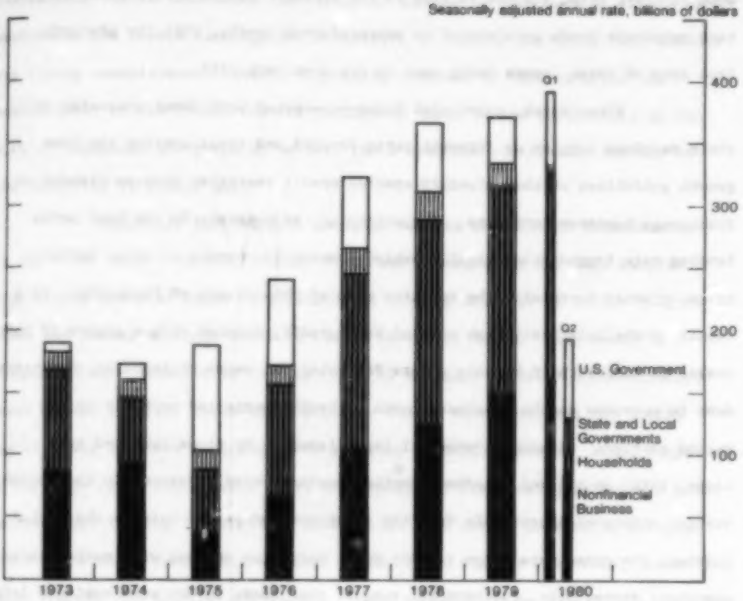
Domestic Credit Flows

Net funds raised in credit markets by domestic nonfinancial sectors of the U.S. economy totaled a sizable $391 billion at an annual rate in the first quarter of 1980, but contracted sharply to an estimated $193 billion in the second period. This exceptionally large decline in borrowing reflected in large part the recent sudden weakening in production and sales activity; in addition, monetary restraint, supplemented by the special policy actions of mid-March, contributed to tauter credit terms and reduced availability of funds at many lenders.

In the private sector, the volume of funds raised in the first quarter was greatly enlarged by a surge in borrowing on the part of nonfinancial business firms. Some of this increased borrowing reflected needs to finance growth in inventories and fixed capital outlays, as the gap between such expenditures and internally generated funds of nonfinancial corporations widened. But fears that unchecked inflation would lead to the imposition of credit controls and a consequent reduction in credit availability apparently led to a burst of anticipatory borrowing by firms as well. As a result, corporations added substantially to their holdings of liquid assets in the first quarter and appear to have drawn down these holdings in subsequent months.

As interest rates moved up rapidly early in the year, businesses concentrated their credit demands in short- and intermediate-term markets, with borrowing at banks and in the commercial paper markets especially heavy. Corporate bond financing remained relatively low as businesses, especially industrial firms, were reluctant to issue long-term debt at historically high

Net Funds Raised in Credit Markets
By Domestic Nonfinancial Sectors



Source: Federal Reserve Board Flow of Funds Accounts. Data for 1980 Q2 are partially estimated.

yields. This pattern of corporate financing shifted dramatically, however, when interest rates dropped rapidly in the spring. Public offerings of longer-term corporate bonds accelerated to unprecedented levels, with the proceeds from many of these issues being used to pay down bank debt.

After March, commercial banks--concerned both about pressures on their earnings margins as interest rates dropped and about meeting the loan growth guidelines of the voluntary special credit restraint program--tended to discourage business borrowers. In particular, adjustments in the bank prime lending rate lagged substantially behind downward movements in other market rates, greatly increasing the relative cost of this source of financing. As a result of the relatively high cost of bank credit, coupled with a desire of businesses to adjust their balance sheets following the heavy reliance on short-term debt in previous months, business loans at banks contracted markedly in the second quarter. Although commercial paper issuance by firms remained very large, total short- and intermediate-term business credit demands in the second quarter moderated appreciably from the first-quarter pace. Late in the second quarter, the prime rate began to move down, narrowing the gap with market rates somewhat; survey data, furthermore, suggest that banks in May were making a large share of short-term business loans at below-prime interest rates.

In the household sector, consumers greatly reduced their use of installment credit during the first half. The large growth of consumer installment and mortgage debt in 1979--both in absolute terms and in relation to disposable income--had produced a marked deterioration in household liquidity. The combination of resulting heavy debt burdens, high interest rates, and, in some states, restrictive usury ceilings acted to slow growth of installment credit in late 1979 and the first quarter of 1980. The volume of outstanding installment credit contracted in the second quarter as consumers curtailed expenditures and repaid debt against a backdrop of rapidly declining real incomes and rising unemployment. Credit-tightening measures by lenders after the announcement of the credit-control package on March 14 and uncertainty on the part of consumers about the effects of those controls contributed further to the reduction in credit use.

Household borrowing in mortgage markets also slowed considerably in the first half. Reduced deposit flows and pressures on earnings margins from rising costs of funds constrained the lending activity of thrift institutions and pushed mortgage rates to record levels in March. Many would-be homebuyers were deterred by the high cost of mortgage credit. More recently, lower market interest rates have helped to reduce cost pressures for thrift institutions and have contributed to a pickup in deposit flows. Sharp drops in mortgage rates since early April and reports of some easing in nonrate terms suggest that lending institutions have become more active in seeking mortgage loans since early June. But mortgage rates remain high by historical standards, while demands for housing and housing credit continue to be damped by a weak economy and by the liquidity concerns of households; consequently, mortgage commitment activity apparently has remained relatively sluggish.

The Treasury borrowed heavily in credit markets in the first half to finance the combined deficits of the federal government and off-budget agencies. Normal seasonal patterns in federal cash flows associated with the timing of tax receipts led to a concentration of the Treasury's borrowing in the first three months of the year. Although the first-quarter deficit was further deepened this year by unusually large tax refunds associated with overwithholding in 1979, the Treasury was able to even out its borrowing pattern somewhat by permitting its cash balance to drop over the first quarter and then rebuilding it in the second.

In contrast to the federal sector, net borrowing by state and local governments dropped off in the first quarter but accelerated appreciably in the second. Many municipal governments postponed or canceled scheduled bond issues early in the year because of high interest rates; for some governmental units, these actions were necessitated by the rise of interest rates above statutory limitations. But the volume of tax-exempt financing picked up considerably in the second quarter when interest rates fell and many previously postponed bond issues were brought to market. The financing needs of state and local units generally increased over the first half in response to slower growth of revenues and a consequent widening of their operating deficits. In addition, the volume of tax-exempt securities issued continued to be boosted by offerings of mortgage revenue bonds, designed to finance single-family housing.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

July 21, 1980

The Honorable William Proxmire
Chairman
Committee on Banking, Housing
  and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Chairman Proxmire:

I am responding further to your joint letter of March 24 with Senator Sarbanes concerning your interest in keeping informed of developments under the Special Credit Restraint Program. In this connection, I am pleased to enclose a staff interim report on that program. The report describes the program and summarizes the statistical and other information, especially that pertaining to bank lending to small businesses and loans for purely financial or speculative purposes, provided in the reports for March and April which certain large financial institutions were required to file. Reports for the month of June, including the first reports from intermediate-size banks, are now being reviewed and processed at each Federal Reserve Bank.

There are also enclosed reports by the staff on the other parts of the Federal Reserve Credit Restraint Program.

I hope you find these reports useful.

Sincerely,

Paul A Volcker

Enclosures

FEDERAL RESERVE CREDIT RESTRAINT PROGRAM

JULY 21, 1980

Interim reports by the staff
Board of Governors of the Federal Reserve System

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THE SPECIAL CREDIT RESTRAINT PROGRAM

The Special Credit Restraint Program (SCRP) was one of several credit restraint measures announced by the Board of Governors on March 14, 1980, in coordination with the overall anti-inflation program announced by President Carter that day. The purpose of these credit restraint measures, which were adopted in part under authority given to the Board by the President's invocation of the Credit Control Act of 1969, was to supplement and reinforce the more general measures of monetary and credit control. They were viewed as temporary measures, to be phased out as quickly as appropriate; accordingly, the restraints were relaxed on May 22, and on July 3 the Board announced their termination. (See Appendix A for the Executive Order and the Board's statements of March 14, May 22, and July 3.)

The Special Credit Restraint Program was designed to limit expansion in bank loans in 1980 to a rate consistent with the announced growth ranges for money and credit, and to do so by discouraging certain types of lending while putting no special restraint on others. This report describes its nature and administration, and summarizes the information collected in connection with the program. Experience with SCRP, though brief, may provide a basis for evaluating this general method of influencing the growth in bank credit.

Background

Growth in bank loans outstanding, after slowing markedly in the fourth quarter of 1979, increased sharply in January and February of this year. The acceleration was widespread. Expansion in total loans to domestic borrowers, at both large and small domestic banks, was about three times as rapid in January-February as in the fourth quarter, and at foreign-related institutions it increased from a 20 percent seasonally adjusted annual rate to 30 percent in January and to more than 40 percent in February. Data for large banks indicated a continuation of strong growth in total loans through early March.

The rebound in loan expansion was especially pronounced for business loans which increased at an annual rate of more than 20 percent in both January and February, compared with 6 percent in the fourth quarter. Outstanding commercial paper of nonfinancial firms also increased at rates substantially above those in the final quarter of last year. Although business loans at finance companies actually declined during this period, total short- and intermediate-term business credit, which had increased at a 6-1/2 percent annual rate in the fourth quarter, grew at almost a 25 percent rate during both January and February. Moreover, unused commitments for commercial and industrial loans at banks expanded at a 40 percent annual rate from December to February, perhaps reflecting anticipation of additional official actions to slow credit growth but in any event creating the potential for substantial loan growth in coming months.

Although the increases in real estate and consumer loans were at about the same rate in January and February as in the last quarter of 1979, and security and nonbank financial loans showed almost no change over the two months, the accelerated growth in total loans could not continue without threatening achievement of the restrained growth in money and credit in 1980 which was deemed necessary to help curb inflation. In the circumstances then prevailing, longer-term competitive considerations apparently made many banks reluctant to restrain new credits or commitments (except by increasing interest rates) even though loan growth raised questions about their ability to acquire the necessary funds within the framework of the Federal Reserve's own targets for money and credit expansion. In this environment, a supplemental program to restrain loan growth seemed appropriate, so long as the burden of the restraint did not fall on those classes of borrowers least able to bear it.

Nature of the Special Credit Restraint Program

The program which the Board adopted was directed primarily at domestic lending by banks and finance companies, but other lenders were requested to observe its guidelines. Under the program, banks were asked to keep expansion of their total loans to U.S. borrowers in 1980 to a rate which did not exceed 6 to 9 percent. In order to avoid interfering with banks' own lending decisions so far as possible and to permit flexibility in meeting customer requirements, the program included no quantitative guidelines with respect to the allocation among classes of borrowers or loan types of the total amount of credit that could be advanced under the 6 to 9 percent growth limitation. Rather, qualitative guidelines were provided; these were included in the March 14 announcement of the program.

> "The Board does not intend to set forth numerical guidelines for particular types of credit. However, banks are encouraged particularly:
>
> (1) To restrain unsecured lending to consumers, including credit cards and other revolving credits. Credit for auto, home mortgage and home improvement loans should not be subject to extraordinary restraint.

> (2) To discourage financing of corporate takeovers or mergers and the retirement of corporate stock, except in those limited instances in which there is a clear justification in terms of production or economic efficiency commensurate with the size of the loan.
>
> (3) To avoid financing of purely speculative holdings of commodities or precious metals or extraordinary inventory accumulation out of keeping with business operating needs.
>
> (4) To maintain reasonable availability of funds to small businesses, farmers, and others without access to other forms of financing.
>
> (5) To restrain the growth in commitments for backup lines in support of commercial paper.
>
> (6) To maintain adequate flow of credit to smaller correspondent banks serving agricultural areas and small business needs and thrift institutions.
>
> The terms and pricing of bank loans are expected to reflect the general circumstances of the marketplace. No specific guidelines or formulas are suggested. However, the Board does not feel it appropriate that lending rates be calculated in a manner that reflects the cost of relatively small amounts of marginal funds subject to the marginal reserve requirements on managed liabilities. Moreover, the Board expects that banks, as appropriate and possible, will adjust lending rates and other terms to take account of the special needs of small businesses, including farmers and others."

As questions arose about the application of these guidelines, they were further explained and developed in press releases or letters to all respondents. (See Appendix B.) For example, guidelines (4) and (6) above reportedly were being interpreted too narrowly by many banks, while other banks anticipated difficulties in observing them. Applications from certain types of borrowers apparently were being denied on the justification that borrowers not specifically mentioned in guidelines (4) and (6) had no preferred status in the program; there were complaints, for instance, that auto dealers were finding it impossible to obtain bank financing even though most of them would qualify as small businesses. At the same time, banks that specialize in lending to small businesses and/or farmers anticipated that they would be unable to meet the needs of these customers without exceeding the 6 to 9 percent limitation. In letters of April 17 and May 22 from Chairman Volcker to all banking institutions, it was made clear that priority borrowers included auto dealers and buyers, homebuilders, and homebuyers (including home improvement and energy conservation loans), and banks were told that exceeding the 9 percent ceiling would be acceptable if they could demonstrate that loan expansion was essentially restricted to priority areas.

In order to assist in monitoring compliance of individual lenders with the program guidelines, regular reports were required from certain institutions. Monthly reports were required from U.S. commercial banks with consolidated U.S. total assets of $1 billion or more, U.S. branches and agencies of foreign banks with worldwide banking assets of more than $1 billion, U.S. bank holding companies with U.S. consolidated financial assets of $1 billion or more, and finance companies with total business receivables of $1 billion or more. Reporting by these institutions changed to bi-monthly when the overall credit restraint program was relaxed on May 22.

In order to assist in monitoring shifts to other sources of financing when the ceiling on bank loan growth constrained availability of bank loans to such borrowers, a group of large corporations was required to file monthly reports which covered their borrowing in the commercial paper market and from foreign sources. This reporting requirement was rescinded on May 22, effective with the report for April.

Finally, U.S. commercial banks with consolidated U.S. total assets of $300 million or more but less than $1 billion were to file quarterly reports; the first and only report for these banks covered activity through June.

All reports were filed with and reviewed by the Federal Reserve Bank in which the respondent was located.

The reporting forms were designed to impose as little additional reporting burden on respondents as possible, even at the loss of some desirable precision. Information required from banking institutions and finance companies was largely qualitative in nature and primarily involved check answers on the strength of credit demands and the proportion of loan applications approved during the reporting month. Several items of explanatory material were also required, including brief descriptions of small-business loan programs and of any approvals or takedowns during the month of loans for purely financial or speculative purposes.

The statistical information which the respondents had to provide was for the most part identical in definition to data they provide regularly for other reports. For example, most items of statistical information on the reporting form for commercial banks were defined exactly as on the quarterly Report of Condition and could be referenced to that report.

In some cases, however, data which respondents were asked to supply either were not available from their records or were not available on a timely basis. Although they were asked to provide their best estimate if actual data were not available, a number of respondents were most reluctant to do so, even when pressed, since they had no related or past records on which to base such an estimate. As was anticipated, the item on loans to smaller businesses—a very important item for assessing compliance with the program guidelines—was particularly difficult for respondents to provide. (Since reporting of financial and speculative loans would have been even more difficult, if not impossible, dollar amounts for such lending were requested only for loan approvals and takedowns during the reporting month.)

Other troublesome items were those involving data for foreign offices. Such information generally was not available either as of the reporting date or by the date when the report was supposed to be filed; this difficulty was resolved by adjustment of the reporting date, use of preliminary estimates, or a moderate extension of the filing date. The group of nonfinancial companies, which was asked for items of statistical information only, reportedly found it quite burdensome to develop data on their indebtedness to foreign entities, especially their net position with their foreign subsidiaries.

Dissemination of Information about the Program

Detailed information about the Special Credit Restraint Program was conveyed quickly by Reserve Banks to financial institutions, and by them to their lending officers.

Immediately after announcement of the program, officials of every Federal Reserve Bank began meeting with lenders and others in the District to describe the program to them and answer their initial questions. Subjects covered included: the need for such a program and the general philosophy of this one; the qualitative and quantitative guidelines; reporting requirements; and plans for monitoring individual-lender performance.

The way in which lenders were informed about the program varied from one Reserve Bank to another mainly in the extent to which lenders were contacted individually or were invited to a group meeting. A fairly typical procedure was for the president of the Bank to contact each of the largest commercial banks in the District individually, by phone or personal visit. This was followed by a series of group meetings with the president and/or other officers of the Bank. Invitations to attend were extended to lending institutions subject to the program's reporting requirements and also to those that did not need to file reports but were expected to observe the program guidelines--as well as to the large nonfinancial corporations that were required to report on certain of their borrowing activities. Meetings were held not only at the Reserve Bank but also in cities throughout the District.

An equally important part of the dissemination process was the adoption of procedures for providing prompt answers to questions about SCRP and the other credit restraint measures, raised by lenders as they began reexamining their lending policies, discussing the program within their institution and preparing to file their first reports. Given the lack of experience with these kinds of measures, the short lead time between announcement of the program and the first SCRP reporting date, and the even shorter lead time for Board staff to develop report forms, instructions and definitions for the various parts of the program, it was inevitable that a host of ambiguities, omissions and inconsistencies would need to be resolved. Some Reserve Banks received several thousand phone inquiries during the early stages of the credit restraint program and assembled special teams to respond to them. Coordination and guidance in resolving difficult questions were provided by daily conference calls between Reserve Banks and Board staff.

Reactions of lenders at their individual and group meetings with Reserve Bank officials had been generally very cooperative. They had expressed understanding of the overall intent of the SCRP program and had indicated their willingness to comply with the guidelines, which many of them felt would reinforce lending policies they already had in train. The 6 to 9 percent limitation was considered reasonable, even by those who expected to have difficulty staying within it. These attitudes were reflected in the guidelines institutions issued to their lending officers.

A question on the report form asked whether the institution had transmitted the content of the Board's March 14 announcement to the appropriate lending officers at each of its U.S. offices. A second question asked whether it had issued specific guidelines to these officers; if so, a copy was to be enclosed with the institution's March report.

Examination of the responses by banks to these questions shows that they moved quickly to inform loan officers of the content of the program and to develop guidelines to ensure achieving its goals. The few banks that had not issued specific guidelines by the end of March reported that they were still in the process of developing appropriate ones.

Although the guidelines issued by many banks were simply paraphrases of those included in the Board's announcement, the more detailed ones followed a general pattern. There was an emphasis at regional banks on continuing to serve local and regional businesses and existing customers. Where changes from this policy were noted, most banks said that no loans for speculative purposes would be considered, even if they had been made in the past, and most placed restrictions on the types of financial loans that would be made. Particular consideration was to be given to loans to support or finance acquisitions of local and regional businesses that otherwise might fail. The guidelines issued by many banks reflected considerable concern over the impact of the recession on their local economy, and placed increased emphasis on quality considerations in approving loans.

Most "families" of U.S. branches and agencies indicated that they had informed loan officers of the contents of the Board's announcement, and most of the larger families had issued specific guidelines to them--either by writing their own or simply sending a copy of the Board's guidelines. In many cases, the reporting institution noted that it did not need to issue formal written guidelines--because it had a small number of loan officers or only one office, because all commitments were reviewed and controlled at one office, or because it had frequent meetings of loan officers at which compliance with the Board's guidelines would be discussed.

Summary of Information Provided in SCRP Reports

SCRP reports were required for the months of March, April and June. The reports for March, of course,--especially for banks which reported as of the last Wednesday of the month--for the most part reflected developments prior to announcement of the program. Reports for June, which were due by July 10 for most respondents, are now being reviewed and processed at the Reserve Banks. Thus, the reports examined in this summary are largely those for the month of April. Information provided by respondents with respect to lending to smaller businesses and loans for purely financial and speculative purposes are discussed in separate sections. (See Appendix C for statistical summaries of responses by each type of reporter; additional tabulations, providing selected data by size of institution and by Federal Reserve District, will be available shortly.)

Weekly data for large banks indicated a continuation of sharp loan growth through early March, followed by much slower growth over the remainder of the month which reduced total loan expansion in March to a seasonally adjusted annual rate of only 2-1/2 percent compared with growth rates of 15-20 percent in January and February. In April, loans outstanding declined at a 5 percent annual rate, and they dropped further in May and June.

It is difficult, if not impossible, to say how much of the weakness in bank loans since early March has been due to the recession, how much to reaction to fiscal announcements and general credit conditions (including expectational effects), how much to the cumulative effects of earlier overall restraints, and how much to the credit restraint programs. But the timing and the abruptness of the change in loan growth trends suggest that announcement of the programs played a significant role. Indeed the immediate effect of the programs on bank lending may have been exaggerated by the initial reactions of lenders to these restraints, as they sought to evaluate what the Federal Reserve actions--especially the 6 to 9 percent limitation--would mean in their particular case, and to obtain clarification on a number of points.

As of mid-March, it appeared that loan growth at a number of banks in the first quarter alone was already close to the 9 percent ceiling for the entire year, and that at many other banks it had been running at an annualized (not seasonally adjusted) rate in excess of 9 percent. By the end of April, however, loan growth for the year to date exceeded 9 percent at only three banks. Each had experienced rapid loan growth early in the year; one had already greatly slowed its rate by loan expansion, one was still showing rapid growth because of its large volume of prior binding commitments but expected to be under the ceiling by year-end, and much of the overage for the third in April reflected a temporary situation.

At 27 additional banks, loan expansion over the first four months of the year amounted to more than 3 percent (annualized rate of more than 9 percent) but, given the continuing weakness in loans, it appeared unlikely that they would have had difficulty staying under the ceiling. For 78, or nearly half, of the reporting banks, total loans declined over the first four months. (Loans usually decline seasonally in the early months of the year.)

Among the 139 U.S. branch and agency families that were required to file reports, 62 reported declines in total loans to U.S. borrowers through April, but 58 showed increases of more than 9 percent. This apparent gross noncompliance needs to be viewed in the context of the very rapid growth in their loans earlier in the year--more than 35 percent at a seasonally adjusted annual rate in January-February, compared with about 15 percent for U.S.-chartered commercial banks. The adjustments they faced in reducing their loan growth to the 6 to 9 percent range by year-end were bound to be difficult and costly. Consultations were held with families that reported significant excesses, and they assured the Reserve Bank that they would do all they could to restrain their domestic loan growth so as to show no more than a 9 percent increase by year-end.

The SCRP guidelines encouraged banks to maintain a reasonable flow of credit to such borrowers as homebuyers and farmers. Whether they did so is rather difficult to tell from the data available from the SCRP reports filed by banks for March and April. Real estate loans on residential properties increased slightly less in April than in the same month of 1979, as they did in March, but their relative importance in the banks' portfolios edged up—the only loan category to do so, of those included on the SCRP reporting form, except for loans to smaller businesses. Loans to farmers declined in April, in contrast to an increase in the year-earlier month. But loans to farmers account for only 1 percent of the total loans of these banks—that is, banks with assets of $1 billion or more—and for even less at well over half of the group. Thus the slight decline in agricultural loans which they reported for April may be without significance. The bulk of residential mortgage and particularly agricultural loans by banks are made by smaller banks not covered in this report.

Examination of responses to qualitative questions on the reporting form shows not only a decline in demands for bank credit in April but also reduced willingness on the part of banks to approve loan applications. Respondents were asked to indicate whether total private demands for credit from U.S. borrowers in the current month were significantly greater, essentially unchanged, or significantly less, as compared with the situation generally prevailing in February 1980 and taking account of seasonal patterns. For commercial and industrial loans they were asked to provide the same classification of applications for loans or loan commitments and of the proportion of such applications approved, compared with the same month in recent years.

In both the March and April reports, most banks answered "essentially unchanged" to all three questions. But between March and April, there were marked shifts toward answers of "significantly less." In reporting for the month of March, 18 banks had characterized total private credit demands in this way; for April, 61 did. Only five banks (as compared with 26 in March) were still reporting total credit demands as signficantly greater than usual.

Responses to the question about applications for commercial and industrial loans showed a similar though less dramatic shift, but they also indicated somewhat more strength in such loans than in total credit demands. Nineteen banks in April and 63 in March reported that the number of applications from commercial and industrial borrowers was significantly larger than usual. Loan applications from smaller business borrowers, however, were reported by practically every bank as being unchanged to significantly below normal. Only two banks in April and four in March reported a signficantly larger than usual number of applications from such borrowers. Fifty-two in April and 35 in March (a considerably higher frequency than for all commercial and industrial loans or total credit demands) reported the number of applications from smaller businesses as being considerably smaller than usual.

Responses to the questions on loan approvals also differed for smaller borrowers than for all business borrowers. These questions, it should be noted, applied to the proportion of loan applications approved, not to the number. Only three banks reported a significantly higher than usual proportion in April (17 in March) for all commercial and industrial loan applications; for loans to smaller businesses the figures were zero and two, respectively. But 34 banks in April (29 in March) reported a significantly lower than normal proportion of approvals for all business loans, while only 19 banks in April and 13 in March gave this response for approvals of smaller-business loan applications. Thus it appears that, although an increased number of banks have reduced the proportion of business loan applications they approve, the change in policy has affected larger business borrowers more than smaller ones. Further discussion of lending to smaller businesses appears in the next section.

Lending to Small Businesses

Each of the large U.S. commercial banks, bank holding companies, and finance companies, and U.S. branches and agencies of large foreign banks which was required to file monthly SCRP reports was asked to answer, and explain, a general question as to whether it has developed a special small-business loan program, and all except bank holding companies were asked to provide statistical data on loans to smaller businesses.[1]

The summary of responses which follows relates primarily to commercial banks. Branches and agencies of foreign banks, with only one or two exceptions, do little lending to small, local businesses (or even to regional ones); they are basically wholesale banks. Bank holding companies, on the other hand, which were asked to report for those bank and nonbank subsidiaries that were not required to file separate reports, indicated that these smaller subsidiaries are generally regional institutions. As such, they do not need to develop special small-business programs because most of their business customers are small and lending officers are attuned to their individual credit needs and problems. Finance company respondents also reported that almost all of their business customers are local, or at most regional, firms and are better served by flexible adjustment of lending terms rather than by establishment of a formal program.

Special Lending Programs

Roughly 60 percent of the reporting banks answered "yes" to the question of whether they had "developed a special program to assist the financing needs of smaller businesses." The distinction between "yes" and "no" answers to this question was quite blurred, however; for example, some banks that answered "yes" described their special program as active participation in Small Business Administration programs, while some that answered "no" gave such participation as the reason why they had not developed their own program. For this reason, some of the descriptive responses need to be considered together, regardless of whether they were submitted in explanation of a "yes" or a "no" answer to the general question.

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[1] With respect to the definition of smaller businesses, respondents were instructed as follows: "As a general guideline, a smaller business might be one whose activities are local, or at most regional, in scope; whose loan takedowns normally do not exceed $500 thousand; and whose total loans outstanding are less than $1-1/2 million. In the event that you cannot classify borrowers according to this definition, use your best judgment as to which of your business customers come closest to it."

About half of the banks that reported having a special program for loans to small businesses (and 29 percent of all reporting banks) said that their program included a small-business base rate which was below the bank's prime rate. (See table on page 18.) The spread below prime varied from 1/2 to 2-1/2 percentage points. A few banks reported a cap on small-business loan rates, but in some cases these caps exceeded 20 percent. Many respondents indicated that the special base rate would disappear if other interest rates fell below some specified levels--for example, if the large-business prime was 12 percent or less. It is not possible to tell from the individual bank responses how many banks plan to make their small-business rate a permanent feature of their lending policies, and how many have adopted such a rate only to provide some relief to their smaller business customers during a period of extraordinarily high interest rates.

Only two banks had established programs designed to alleviate short-term cash flow problems of small firms by maintaining a level payment of interest or interest plus principal. Under such programs, interest liabilities continue to accrue but payments are deferred until, for example, interest rates decline or the principal is repaid. One bank allowed for the possibility of extending the loan maturity in order to hold down periodic payments. Among banks without a formal program of this type, several said

Commercial Bank Programs to Assist Small Business Financing Needs
Summary of Special Credit Restraint Program Reports

	Number of banks	Percent of Total 1/	
All large reporting banks	168	100	
YES, have special program	98	58	100
NO, do not have special program	70	42	100
If "YES," program described as including:			
a. Small business base rate below prime	48	29	49
b. Active participation in SBA or other government program	39	23	40
c. Special small business department or community program	22	13	22
d. Deferred interest payment	2	1	2
e. Other	13	8	13
If "NO," reason given:			
a. Most loans are to small business	21	13	30
b. Participate in SBA program	8	5	11
c. Wholesale bank, make no or few small business loans	8	5	11
d. In process of formalizing special program	17	10	24
e. Other	19	11	27

1/ Sums are greater than 100 percent because some banks reported more than one characteristic or reason.

they had asked their lending officers to consult with regular customers concerning potential cash flow problems.

Somewhat over one-fourth of all reporting banks cited participation in SBA or other government-guaranteed assistance programs as either the primary feature, or one of several features, of their lending to small business. About half that many indicated that they had special small-business loan departments or community programs within the bank, or were active members of local development groups.

A variety of statements about their small-business lending activities, provided by nearly one-fifth of the respondent banks (either to justify "yes" answers to the general question or to explain "no" answers) have been classified as "other" in the table. Examples of such activities are: seeking out new businesses or other small firms that may need credit, rather than waiting for such businesses to come to them; assignment of a senior vice-president to work with small businesses; establishment of a "small-business loan team" within the commercial loan department; preparation of advertisements and brochures on the kinds of available loan arrangements and how to draw up a loan application; custom-tailoring of each loan agreement to the needs and repayment ability of the particular borrower; an ongoing and aggressive marketing strategy to increase the bank's lending to smaller businesses; willingness to accept higher than usual credit risks, to be more lenient with the borrower's performance, or otherwise to give preferential treatment to smaller businesses.

Ten percent of the banks reported that, while they have no formal small-business loan program at present, they are in the process of developing one. Another 13 percent said that they do not need a special program, since they are small-business oriented and almost all the loans on their books have been extended to such firms.

Finally, five percent of the banks characterized themselves as wholesale banks, with no use for a special small-business lending policy because they make virtually no loans to such businesses. Only a very few banks stated bluntly that no special program was needed since all legitimate demands were being met.

In short, almost every bank reporting under the program claimed that, in one way or another, it is making a serious effort to meet the credit needs of the smaller businesses in its market area. Only small businesses themselves could say how effective these efforts really are. While other Federal Reserve data suggest banks have extended significant amounts of loans at rates below prime, the volume of bank loans outstanding to smaller firms appears to have increased less this year than loans to larger businesses. It should be noted, however, that present bank records seldom permit precise measurement of loan totals by size of borrower, and thus the data summarized below rest primarily on good-faith estimates.

Volume of Small-Business Loans

The data that banks reported on loans outstanding suggest that, despite the banks' own small-business programs and the guidelines of the Special Credit Restraint Program with respect to loans to smaller businesses, growth in such loans has lagged the growth in loans to larger firms. It is possible, of course, that the shortfall has been primarily demand-induced.

On a year-to-year basis, growth in loans to smaller businesses in March and April was only half as large as the growth in commercial and industrial loans to all U.S. addressees. (See table on page 22.) The shortfall in February (not shown in the table) was somewhat smaller. On a month-to-month basis, differences in March and April between the change in commercial and industrial loans to smaller businesses and in such loans to all U.S. addressees were less uniform. However, the data do indicate sharper cutbacks in lending to large businesses than to smaller ones in April--the first full month of the Special Credit Restraint Program.

For the reporting banks as a group, loans to smaller businesses have accounted for a slightly smaller proportion of total commercial and industrial loans this year--the proportion was 20 to 20-1/2 percent in February, March and April 1980, compared with 21-1/2 percent in each of the same months last year. Median proportions, however, are running a bit higher this year than last. It should be noted that all of these proportions are understated to an unknown extent. A number of banks, including some with rather extensive small-business loan programs, said they were unable to provide even an estimate of the volume of loans

Selected Data on Commercial and Industrial Loans to Smaller Businesses and All U.S. Addressees All Reporting Banks

	March		April	
	1979	1980	1979	1980
	Percent change from year earlier			
Aggregate change				
Smaller businesses	n.a.	8.9	n.a.	7.1
All U.S. addressees	n.a.	18.1	n.a.	14.2
Median change				
Smaller businesses	n.a.	6.5	n.a.	4.9
All U.S. addressees	n.a.	11.5	n.a.	9.4
	Percent change from preceding month			
Aggregate change				
Smaller businesses	2.2	0.4	2.9	1.2
All U.S. addressees	2.0	1.6	3.1	-0.2
Median change				
Smaller businesses	1.3	0.4	1.9	-0.5
All U.S. addressees	2.3	1.0	2.6	-0.3
	Percent of total commercial and industrial loans			
Aggregate				
Smaller businesses	21.5	20.0	21.5	20.6
All U.S. addressees	93.7	94.4	94.0	96.0
Median				
Smaller businesses	29.3	30.0	28.9	30.8
All U.S. addressees	98.3	98.1	98.1	98.3

Note: For more detail, see tables in Appendix C.

outstanding to smaller businesses; some said they were revising their computer programs to enable them to provide such information in the future.

For other reporters, the ratio of small-business loans to total commercial and industrial loans has shown no change this year. It has continued at less than 2 percent for U.S. branches and agencies as a group and at over 60 percent for reporting finance companies. Bank holding companies were not asked to provide data on loans outstanding to smaller businesses.

Loans for Purely Financial or for Speculative Purposes

In October 1979, Chairman Volcker requested commercial banks to refrain from financing corporate takeovers, except where fully justified in terms of increased production or improved efficiency, and to refrain also from financing speculative activities. These requests were repeated in the SCRP guidelines, and the report forms for banks--as well as for U.S. branches and agencies, bank holding companies, and finance companies--asked a set of questions about such loans. Separately for each type of purpose (purely financial and speculative), each respondent was to indicate whether, during the current month and with respect to commercial and industrial loans, there had been any requests, any approvals, or any takedowns under prior (before March 1980) commitments. A brief description of the loan was required for each approval or takedown.

Two aspects of these questions are important in interpreting the answers given: the questions covered activity during the current month, not outstandings; and they related to commercial and industrial loans only, not to loans in other call report categories. This means that some well-publicized takeover and speculative loans would not have been reported if they were approved and disbursed prior to March 1980, or if the loan would normally be classified elsewhere, for example, as a loan to an individual or financial instituion, or as a security loan. On the other hand, some banks apparently did include these other loan categories in answering the question, thus overstating the number of approvals and takedowns of commercial and industrial loans for financial and speculative purposes.

Loans for Purely Financial Purposes

Of the 170 large commercial banks reporting under the program, 71 indicated that they had received one or more requests or applications in April for loans or loan commitments for this purpose. Thirty-four reported having approved such financings in April and 23 said there had been takedowns under commitments made before March 1980. Comparable figures for March were somewhat higher--80, 38, and 32, respectively.

For U.S. branches and agencies of foreign banks, 13 of the 139 reporters indicated that they had received requests for this type of financing in April, but only two reported approvals and two reported takedowns on prior commitments. Twenty-nine of the 161 bank holding company respondents reported applications in April for loans for financial purposes. with 10 reporting approvals and 5 reporting takedowns. Only 1 of the 15 large finance companies reported such a request and 1 reported an approval.

Commercial banks reported 45 separate approvals of loans for purely financial purposes in April and 30 separate takedowns on prior commitments. The average size of these loans was surprisingly small:

a significant proportion were for $500 thousand or less, and the median size was $900 thousand for approvals and $800 thousand for takedowns. Only five approvals and two takedowns were for more than $5 million. Size of loan was not indicated for three approvals and four takedowns, but only one of each seems likely to have been larger than $5 million.

Loans for Purely Financial Purposes
Size Distribution

	Number of Loans, April, 1980	
	Approvals	Takedowns on prior commitments
(Median size, thousands of dollars	900	800)
$500 thousand or less	16	11
$500 thousand - $1 million	8	3
$1 million - $2 million	6	6
$2 million - $5 million	7	4
More than $5 million	5	2
Size not available	3	4
	45	30

Most of the approvals of loans for financial purposes reported by commercial banks for April appear to have been for financings that were consistent with the program guidelines. As may be seen from the table on page 26, the majority approved in April, as in March, were for acquistions of one kind or another. Eight were to finance purchases from retiring owners (and thereby keep the firm in existence) or to acquire failing or bankrupt businesses, and four were to provide the firm with new management which the bank felt would improve its productive efficiency or better meet the needs of the community. Five were to finance the acquisition of a bank by (generally) a new one-bank holding company. Three were associated

Loans for Purely Financial Purposes
Nature of Loans Approved in April 1980

	Number of Loans
Acquisition	**32**
To buy interest of retiring or deceased owners	6
To purchase failing or bankrupt firm	2
To improve efficiency or service to community	4
By present management or employees (ESOP)	2
By one-bank holding company	5
To complete prior purchase	2
For expansion of own business line	3
Detail not provided	8
Financial restructuring or debt refinancing	5
Purchase of own shares	**4**
From retiring shareholder or partner	2
Under contractual agreement with shareholder	1
To transfer ownership to ESOP	1
Other	**2**
To purchase stock from estate	1
To increase contribution to partnership	1
Nature not indicated	2

with transfer of ownership to the firm's current management or to its employees through an employee stock ownership plan. None of the approvals of loans to finance purchase of the company's own shares was for the sole purpose of permitting the firm to retire the stock; retirement, if it in fact occurred, was incidental to the primary reason for the repurchase.

However, some of the loans approved in April may have supported financings which were not in compliance with the spirit of the program or which could reasonably have been postponed. Acquisitions for expansion purposes are an example, as are at least some of the loans for financial restructuring or debt refinancing (although one of the latter--an advance approval of part of the huge loan finalized later for refinancing of silver debts--was rather urgent). And the possibility exists that some of the eight loans for vague acquisition purposes and the two loans to individuals for unspecified purposes were contrary to the program guidelines.

Much less information was provided for takedowns on prior commitments than for loan approvals. Of the 30 such takedowns in April reported by commercial banks, 15 were for acquisition or merger financing and 11 of these were not identified further. Six takedowns were to finance purchase of own stock; in three cases, no further description of the purchase was given, and in three the purchase was defined only as for retirement of the stock. Seven of the remaining takedowns were loans for the purpose of purchasing securities or unidentified loans to individuals.

Although at least some of the acquisitions and stock repurchases financed by these takedowns undoubtedly were for purposes that would not have been justifiable under the program if the commitment had been made after March 14, all of the takedowns reported here were under commitments made before that date. It was recognized from the start of the program that the need to honor pre-existing binding commitments would limit the ability of many banks to take on new loans of the types favored in the guidelines. Banks did pull back on some prior negotiations; borrower complaints reaching the Federal Reserve after the program was announced indicated that banks were refusing to honor some understandings with respect to loans for relatively unproductive purposes if the commitment was not legally or morally binding.

With respect to the binding commitments which had to be honored, however, it may be noted that the reported date of the commitment underlying the actual takedowns in April of loans for purely financial purposes was in late 1979 or early 1980 in almost every case--before announcement of SCRP but after receipt of Chairman Volcker's letters of last October discouraging such loans. Negotiations on some of these commitments may have been so far along by October that the bank felt obligated to carry them through to completion. But it may also be that the more detailed guidelines and the reporting requirements announced in March were more effective deterrents than the earlier cautionary statements. In any event, the Federal Reserve Banks, in selected instances, are reviewing these situations with individual banks.

As the program continued, but before its termination, increasingly urgent questions arose concerning the appropriateness of particular propositions for takeover loans. The question of "defensive" financing of possible U.S. buyers arose in several instances where there were potential foreign buyers. No affirmative indications were given, but prolongation of the program would necessarily have entailed difficult and potentially arbitrary decisions.

Loans for Speculative Purposes

Very few respondents reported approvals or takedowns of commercial and industrial loans or commitments for speculative purposes in March or April. As suggested earlier, there may have been additional disbursements for such purposes, which would not be classified as commercial and industrial loans.

Among reporting commercial banks, 41 indicated that in April they had received requests or applications for commercial and industrial loans or commitments for speculative purposes, but only 5 reported approvals for such requests and only 4 reported takedowns under commitments made before March 1980; comparable figures for the month of March were 47 requests, 9 approvals, and 7 takedowns. Three U.S. branches and agencies reported requests in April (5 in March) for such financings, but no approvals or takedowns (2 takedowns in March were reported). Requests were reported by 26 bank holding companies, approvals by 4, and takedowns by 3. No finance company respondent reported any requests, approvals or takedowns in either month.

Although, as noted above, five banks reported approvals in April of commercial and industrial loans or commitments for financing of speculative activities, there is some question as to whether all of them should have been so classified. Three banks included their participation in the

Placid Oil/Hunt silver refinancing.[1] (Another bank had considered its participation to be a loan for a purely financial purpose.) Another April approval was a small, very short-term loan to an individual for a speculative commodity purchase. The remaining approvals reported were also for relatively modest amounts. They included: a loan to a developer to enable him to acquire land adjacent to land he already owned; inventory loans to protect the business against an anticipated interruption in the flow of supplies or to take advantage of a reduced price for materials; and a loan to a small-business customer to acquire land adjacent to its plant.

All takedowns under prior commitments for financing of speculative activities reported by banks for the month of April involved relatively small amounts--a few hundred thousand dollars at most. As was the case with loans for financial purposes, less information was provided on the nature of the prior commitment than on new approvals. Two banks reported what appear to be several very small takedowns, without identifying each one. Another reported takedowns under several commitments for land banking, but indicated that it was making no new commitments of this type. The fourth classified as a speculative loan a takedown to finance an additional contribution of equity to the borrower's company.

As with takeover loans, narrow distinctions are sometimes involved as to what is a speculative loan and what is not. Distinctions of this kind become increasingly difficult to handle in the context of a prolonged program.

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[1] In March, it may be noted, two U.S. banks and one U.S. branch of a foreign bank had reported financings involving the related speculative activities in the silver market.

APPENDIX A

Executive Order 12201
Principal Statements on the Program

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CREDIT CONTROL

By the authority vested in me as President of the United States of America by Section 205 of the Credit Control Act (12 U.S.C. 1904), and having determined that the regulation and control of credit is necessary and appropriate for the purpose of preventing and controlling inflation generated by the extension of credit in an excessive volume, it is hereby ordered as follows:

1-101. The Board of Governors of the Federal Reserve System is authorized to exercise all the authority under the Credit Control Act (12 U.S.C. 1901 et seq.) to regulate and control consumer credit.

1-102. The Board of Governors of the Federal Reserve System is authorized to exercise all the authority under the Credit Control Act to regulate and control credit extended by those financial intermediaries which are not subject, as of the date hereof, to either the amendments of law effected by Public Law 89-597, as amended, or Section 19 of the Federal Reserve Act, as amended (12 U.S.C. 461), and which are primarily engaged in the extension of short-term credit.

1-103. The Board of Governors of the Federal Reserve System is authorized to exercise all the authority under the Credit Control Act to regulate and control credit extended to commercial banks that are not members of the Federal Reserve System in the form of managed liabilities.

1-104. The Board of Governors of the Federal Reserve System is authorized to exercise the authority under Section 206(4) of the Credit Control Act (12 U.S.C. 1905(4)) to prescribe appropriate requirements as to the keeping of records with respect to all forms of credit.

1-105. For the purposes of this Order "consumer credit," "financial intermediaries," "short-term credit," "commercial banks," and "managed liabilities" shall have such meaning as may be reasonably prescribed by the regulations of the Board of Governors of the Federal Reserve System.

1-106. The authorizations granted by this Order shall remain in effect for an indefinite period of time and until revoked by the President.

JIMMY CARTER

THE WHITE HOUSE,
March 14, 1980.

FEDERAL RESERVE press release

For immediate release MARCH 14, 1980

The Federal Reserve Board today announced a series of monetary and credit actions as part of a general government program to help curb inflationary pressures. The actions are:

1. A voluntary Special Credit Restraint Program that will apply to all domestic commercial banks, bank holding companies, business credit extended by finance companies, and credit extended to U.S. residents by the U.S. agencies and branches of foreign banks. The parents and affiliates of those foreign banks are urged to cooperate in similarly restricting their lending to U.S. companies. Special effort will be made to maintain credit for farmers and small businessmen.

2. A program of restraint on certain types of consumer credit, including credit cards, check credit overdraft plans, unsecured personal loans and secured credit where the proceeds are not used to finance the collateral. The Board has established a special deposit requirement of 15 percent for all lenders on increases in covered types of credit. Automobile credit, credit specifically used to finance the purchase of household goods such as furniture and appliances, home improvement loans and mortgage credit are not covered by the program.

3. An increase from 8 percent to 10 percent in the marginal reserve requirement on the managed liabilities of large banks that was first imposed last October 6, and a reduction in the base upon which the reserve requirement is calculated.

4. Restraint on the amount of credit raised by large non-member banks by establishing a special deposit requirement of 10 percent on increases in their managed liabilities.

5. Restraint on the rapid expansion of money market mutual funds by establishing a special deposit requirement of 15 percent on increases in their total assets above the level of March 14.

FEDERAL RESERVE press release

For immediate release March 19, 1980

The following corrections should be made in the material distributed in connection with the Federal Reserve Board's anti-inflation program announced March 14:

1. Covering news release: Page 4, third paragraph, fifth line, at the beginning, read $1 billion (not $5 billion).

2. Part 204--Marginal Reserve Requirement amendments:
   - --Page 5 -- Section 204.5(f)(3)(i)(B), fourth line, read "of other institutions[19] or institutions" omitting "to"; and
   - --Fifth line down in next paragraph read "balances due from foreign offices of other institutions[19] or institutions" omitting "to".
   - --Page 5 -- Fourth line from bottom, make line read: "such differences shall be rounded to the next lowest multiple of $2 million." (inserting "multiple of").

3. Credit Restraint (Subpart B) -- Short Term Financial Intermediaries:
   - --Page 4 -- Place a reference to footnote 1 at end of second line (after word "instrument,") in Paragraph (c), Sec. 229.12.
   - --Page 5 -- Place a reference to footnote 2 in 13th line of Paragraph (d) after the word "less".

4. Part 229--Credit Restraint (Subpart C) -- Nonmember Commercial Banks:
   - --Page 1 -- Effective Date, read dates in the first two sentences as follows:

     > "The special deposit requirement is effective on marginal total managed liabilities outstanding during the seven-day computation period beginning March 20, 1980, and each seven-day period thereafter. The non-interest bearing special deposit for the computation periods beginning March 20, 27 and April 3, 1980, must be held during the deposit maintenance period beginning April 17, 1980."

   - --Page 5 -- Computation and Maintenance of Non-Interest bearing Special Deposits, 16 lines from bottom, read March 19 (not 12) and 10 lines from bottom read March 20 (not 13).
   - --Page 8 -- First sentence in Paragraph (a) read dates April 17 in second line (not 10) and March 20, 27 and April 3 in fifth line (not March 13, 20 and 27), and April 24 in seventh line (not 17).
   - --Page 10 -- Second line of paragraph (b) read date March 20 (not 13).

All these corrections will have been made as this material appears in the Federal Register.

6. A surcharge on discount borrowings by large banks to discourage frequent use of the discount window and to speed bank adjustments in response to restraint on bank reserves. A surcharge of 3 percentage points applies to borrowings by banks with deposits of $500 million or more for more than one week in a row or more than four weeks in any calendar quarter. The basic discount rate remains at 13 percent.

In making the announcement, the Board said:

> "President Carter has announced a broad program of fiscal, energy, credit and other measures designed to moderate and reduce inflationary forces in a manner that can also lay the ground work for a return to stable economic growth.
>
> "Consistent with that objective and with the continuing intent of the Federal Reserve to restrain growth in money and credit during 1980, the Federal Reserve has at the same time taken certain further actions to reinforce the effectiveness of the measures announced in October of 1979. These actions include an increase in the marginal reserve requirements on managed liabilities established on October 6 and a surcharge for large banks on borrowings through the Federal Reserve discount window.
>
> "The President has also provided the Federal Reserve, under the terms of the Credit Control Act of 1969, with authority to exercise particular restraint on the growth of certain types of consumer credit extended by banks and others. That restraint will be achieved through the imposition of a requirement for special deposits equivalent to 15 percent of any expansion of credit provided by credit cards, other forms of unsecured revolving credit, and personal loans.
>
> "One consequence of strong demands for money and credit generated in part by inflationary forces and expectations has been to bring heavy pressure on credit and financial markets generally, with varying impacts on particular sectors of the economy. At the same time, restraint on growth in money and credit must be a fundamental part of the process of restoring stability. That restraint is, and will continue to be, based primarily on control of bank reserves and other traditional instruments of monetary policy. However, the Federal Reserve Board also believes the effectiveness and speed with which appropriate restraint can be achieved without disruptive effects on credit markets will be facilitated by a more formal program of voluntary restraint by important financial intermediaries, developing further the general criteria set forth in earlier communications to member banks."

Special Credit Restraint Program

In adopting this program, the Board said increases in lending this year should generally be consistent with the announced growth ranges for money and credit reported to Congress on February 19. Although growth trends will vary among banks and regions of the country, growth in bank loans should not generally exceed the upper part of the range of 6-9 percent indicated for bank credit (that is, loans and investments). Banks whose past lending patterns suggest relatively slow growth should expect to confine their growth to the lower portion or even below the range for bank credit.

The Board said the commercial paper market and finance companies—both a growing source of business credit—will be monitored closely in the program. Since activity in the commercial paper market is normally covered by bank credit lines, banks are expected to avoid increases in commitments for credit lines to support such borrowing out of keeping with normal business needs. Thrift institutions and credit unions will not be covered by the special program in light of the reduced trend in their asset growth.

No numerical guidelines for particular types of credit are planned but banks are encouraged particularly:

- To restrain unsecured lending to consumers, including credit cards and other revolving credits. Credit for automobiles, home mortgage and home improvement loans should be treated normally in the light of general market conditions.
- To discourage financing of corporate takeovers or mergers and the retirement of corporate stock, except in those limited instances in which there is a clear justification in terms of production or economic efficiency commensurate with the size of the loan.
- To avoid financing for purely speculative holdings of commodities or precious metals or extraordinary inventory accumulation.
- To maintain availability of funds to small business, farmers homebuyers and others without access to other forms of financing.
- To restrain the growth in commitments for back-up lines in support of commercial paper.

No specific guidelines will be issued on the terms and pricing of bank loans. However, rates should not be calculated in a manner that reflects the cost of relatively small amounts of marginal funds subject to the marginal reserve requirement on managed liabilities. The Board also expects that banks, as appropriate and possible, will adjust lending rates and other terms to take account of the special needs of small business and others.

Lenders covered by the program are asked to supply certain data and information. The President, in activating the Credit Control Act, has provided the authority to require such reports.

Monthly reports are requested from domestic banks with assets in excess of $1 billion and for branches and agencies of foreign banks that have worldwide assets in excess of $1 billion. Monthly reports are also requested on the business credit activities of domestic affiliates of bank holding companies with total assets in excess of $5 billion. Banks with assets between $300 million and $1 billion are asked to report quarterly. Smaller institutions need not report unless subsequent developments warrant it.

Foreign banks will be asked to respect the substance and spirit of the guidelines in their loans to U.S. borrowers or loans designed to support U.S. activity.

A panel of large corporations will be asked to report monthly on their commercial paper issues and their borrowings abroad. Finance companies with more than $1 billion in business loans outstanding will also be asked to report monthly on their business credit outstanding.

Consumer Credit Restraint

The special deposit requirements of 15 percent on increases in some types of consumer credit is designed to encourage particular restraint on such credit extensions. Methods used by lenders to achieve such restraint are a matter for determination by the individual firms. Increases in covered credit above the base date—March 14—will be subject to the special deposit requirement.

Among lenders subject to the regulation are commercial banks, finance companies, credit unions, savings and loan associations, mutual savings banks, retail establishments, gasoline companies and travel and entertainment card companies—in all instances where there is $2 million or more in covered credit.

Typical examples of credit that is covered are credit cards issued by financial institutions, retailers and oil companies; overdraft and special check-type credit plans; unsecured personal loans; loans for which the collateral is already owned by the borrower; open account and 30-day credit without regard to whether a finance charge is imposed; credit secured by financial assets when the collateral is not purchased with the proceeds of the loan.

Examples of consumer credit not covered are:

Secured credit where the security is purchased with the proceeds of the loan such as an automobile, mobile home, furniture or appliance; mortgage loans where the proceeds are used to purchase the home or for home improvements; insurance company policy loans, credit extended for utilities, health or educational services; credit extended under State or Federal government guaranteed loan programs; and savings passbook loans.

All creditors with $2 million or more of covered credit outstanding on March 14 must file a base report by April 1 directly with the Federal Reserve or through the Federal Home Loan Bank Board or the Federal Credit Union Administration. This report will state the amount of credit outstanding on March 14 or a figure for the nearest available data.

Thereafter, these creditors must file a monthly report on the amount of covered consumer credit outstanding during the month, based on the daily average amount of covered credit if that data is available, or the amount outstanding on other appropriate dates approved by the Federal Reserve. The first report—for the period from March 15 through April 30—is due by May 12. The report for subsequent months is due by the second Monday of the following month.

The first 15 percent deposit requirement must be maintained beginning May 22 on increases in outstanding credit.

Marginal Reserve Requirement

On October 6, the Board established an 8 percent marginal reserve requirement on increases in managed liabilities that had been actively used to finance a rapid expansion in bank credit. The base for this reserve requirement was set at the larger of $100 million or the average amount of managed liabilities held by a member bank, an Edge corporation, or a family of U.S. agencies and branches of a foreign bank as of September 13-26. Any increase in managed liabilities above that base period was subject to the additional 8 percent reserve requirement.

Managed liabilities include large time deposits ($100,000 or more) with maturities of less than a year, Eurodollar borrowings, repurchase agreements against U.S. government and federal agency securities, and federal funds borrowed from a nonmember institution.

In today's action, the Board increased the reserve requirement to 10 percent and lowered the base by (a) 7 percent or (b) the decrease in a bank's gross loans to foreigners and gross balances due from foreign offices of other institutions between the base period and the week ending March 12, whichever is greater. In addition, the base will be reduced to the extent a bank's foreign loans continue to decline. The minimum base amount remains at $100 million.

Nonmember Banks

The special deposit requirement for nonmember banks is designed to restrain credit expansion in the same manner as the marginal reserve requirement on the managed liabilities of member banks.

For nonmembers, the base is the two-week period that ended March 12 or $100 million, whichever is greater. The 10 percent special deposit will be maintained at the Federal Reserve on increases in managed liabilities above the base amount. The base will be reduced in subsequent periods to the extent that a nonmember bank reduces its foreign loans.

Money Market Mutual Funds

Money market mutual funds and similar creditors must maintain a special deposit with the Federal Reserve equal to 15 percent of the increase in their total assets after March 14.

A covered fund must file by April 1 a base report of its outstanding assets as of March 14. Thereafter, a monthly report on the daily average amount of its assets must be filed by the 21st of the month. For example, a report on the first month's assets—from March 15 to April 14—must be filed by April 21 and the special deposit requirement will be maintained beginning May 1. A fund that registers as an investment company with the Securities and Exchange Commission after March 14 must file a base report within two weeks after it begins operations.

Discount Rate

In fixing the surcharge for large bank borrowing, the Board acted on requests from the directors of all 12 Federal Reserve Banks. The action is effective Monday. The discount rate is the interest rate that member banks are charged when they borrow from their district Federal Reserve Bank.

The surcharge above the basic discount rate would generally be related to market interest rates. It is designed to discourage frequent use of the discount window and to encourage banks with access to money markets to adjust their loans and investments more promptly to changing market conditions. This should facilitate the ability of the Federal Reserve to attain longer-run bank credit and money supply objectives.

The surcharge will apply to banks with more than $500 million in deposits on their borrowings for ordinary adjustment credit, when such borrowing occurs successively in two statement weeks or more, or when the borrowing occurs in more than four weeks in a calendar quarter. There will be no other change in the administration of the discount window with respect to adjustment credit. Such credit will continue to be available to member banks only on a short-term basis to assist them in meeting a temporary requirement for funds or to provide a cushion while orderly adjustments are made in response to more subtained charges in a bank's position.

The surcharge will not apply to borrowing under the seasonal loan program, which will continue at the basic discount rate, nor to borrowing under the emergency loan program.

Attached are copies of the following documents:

1. The Special Credit Restraint Program.
2. Regulation CC establishing a special deposit requirement on increases in certain types of consumer credit.
3. An amendment to Regulation D increasing the marginal reserve requirement on managed liabilities to 10 percent and reducing the base period.
4. A subpart of Regulation CC establishing a special deposit requirement for nonmember banks.
5. A subpart of Regulation CC establishing a special deposit requirement for money market mutual funds.

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Special Credit Restraint Program

Background

President Carter has announced a broad program of fiscal, energy, credit, and other measures designed to moderate and reduce inflationary forces in a manner that can also lay the groundwork for a return to stable economic growth.

In connection with those actions, and consistent with the continuing objective to restrain growth in money and credit during 1980, the Federal Reserve has also taken certain further actions to reinforce the effectiveness of the measures announced in October of 1979. These actions include an increase in the marginal reserve requirements on managed liabilities established on October 6 and the establishment of a surcharge on borrowings through the discount window by large banks.

The President has also authorized the Federal Reserve, under the terms of the Credit Control Act of 1969, to exercise particular restraint on certain types of credit. The Board has determined to restrain the growth of certain types of consumer credit through the imposition of a requirement for special deposits equivalent to 15% of any expansion of consumer credit provided by any lender through credit cards, other forms of unsecured revolving credit, and personal loans. Under the authority of the Credit Control Act, the Federal Reserve has also (a) applied a special deposit requirement on the growth of managed liabilities of large non-member banks and (b) imposed a special deposit requirement on the growth in the net assets of money market mutual funds and other similar entities.

One consequence of strong demands for money and credit generated in part by inflationary forces and expectations has been to bring heavy pressure on credit and financial markets generally, with varying impacts on particular sectors of the economy. At the same time, restraint on growth in money and credit must be a fundamental part of the process of restoring stability. That restraint is, and will continue to be, based primarily on control of bank reserves and other traditional instruments of monetary policy. However, the Federal Reserve Board also believes the effectiveness and speed with which appropriate restraint can be achieved without unnecessarily disruptive effects on credit markets will be facilitated by a program of voluntary credit restraint by important financial intermediaries. The program set forth here develops certain general criteria to help guide banks and others in their lending policies during the period ahead.

Statement of Purpose

The purpose of the Special Credit Restraint Program is to encourage lenders and borrowers, in their individual credit decisions, to take specific account of the overall aims and quantitative objectives of the Federal Reserve in restraining growth in money and credit generally. The guidelines set forth are consistent with the continuing interest of the Federal Reserve and individual institutions to:

- Meet the basic needs of established customers for normal operations, particularly smaller businesses, farmers, thrift institution bank customers, and agriculturally-oriented correspondent banks, and homebuyers with limited alternative sources of funds.
- Avoid use of available credit resources to support essentially speculative uses of funds, including voluntary buildup of inventories by businesses beyond operating needs, or to finance transactions such as takeovers or mergers that can reasonably be postponed, that do not contribute to economic efficiency or productivity, or may be financed from other sources of funds.
- Limit overall loan growth so that adequate provision is made for liquidity and acceptable capital ratios.

In requesting cooperation of individual institutional lenders in achieving the general objectives of this program, the Federal Reserve Board is strongly conscious of the fact that sound decisions concerning the distribution of credit and specific loans can be made only by individual institutions dealing directly in financial markets and intimately familiar with the needs and conditions of particular customers. We are also aware, however, that in existing market circumstances, individual institutions may be under competitive pressure to make loans or commitments that, in the aggregate, cannot be sustained within our overall monetary and credit objectives or that, for particular institutions, may exceed prudent limits. By more clearly considering individual lending and commitment decisions in the light of the national objectives reflected in this program, undue market pressures and disturbances can be avoided and available credit supplies be used to meet more urgent requirements.

Nature of the Program

Coverage

The Special Credit Restraint Program will be directed primarily toward the domestic credit supplied by commercial banks and the domestic business credit extended by finance companies. Surveillance will also be exercised over borrowing in the commercial paper market and borrowings abroad by U.S. corporations.

With regard to domestic commercial banks, the program is designed to cover credit extended to U.S. residents by both the domestic and overseas offices of such banks. Credit extended to U.S. residents by agencies and branches of foreign banks domiciled in the United States will be specifically covered. Affiliates abroad of banks operating in the U.S. are expected to respect the substance and spirit of the guidelines in their loans to U.S. borrowers or loans otherwise designed to support U.S. activity.

In recent months, the commercial paper market and finance companies have been a growing source of business credit. In recognition of this trend and to assure comparable competitive treatment, finance companies (including subsidiaries of bank holding companies) are asked to follow the general guidelines in their business lending.

Activity in the commercial paper market is normally covered by bank credit lines. That practice is strongly encouraged in the interest of continuing to provide a sound base to that market. But the use of commercial paper should be restrained, and growth in the market and activity of the larger users of that market will be closely monitored. For their part, banks are expected to give special attention to avoiding increases in commitments for credit lines for purposes of supporting commercial paper borrowing for other than normal business operating purposes.

Thrift institutions and credit unions are not specifically covered by the Special Program in light of recent patterns in their asset growth.

Reporting arrangements are described below.

Quantitative Guidelines

The Federal Reserve has recently set forth growth ranges for the monetary aggregates for 1980 as follows:

M1A	3½%	-	6%
M1B	4%	-	6½%
M2	6%	-	9%
M3	6½%	-	9½%

The growth ranges set forth for M3 encompass almost all the relatively short-term liabilities of banks and other depository institutions. That liability growth was broadly estimated to be consistent with growth in total bank credit (loans and investments) of 6-9%. We are aware that in current market circumstances, banks may be requested to carry a larger than normal share of growth in business and certain other types of credit. However, prudent attention to liquidity and capital positions will also be required, and liquidity of banks is already somewhat depleted. Taking these factors into account, growth in bank loans, consistent with the monetary growth ranges and maintenance of prudent liquidity positions, should not generally exceed the upper part of the indicated range of growth in total bank credit. That growth should be spread out over time in an orderly fashion, taking account of normal seasonal patterns.

Growth trends vary among banks and regions of the country. Individual institutions will wish to appraise their own prospects and policies in that light. Banks whose past patterns suggest relatively slow growth, and particularly those serving more slowly growing areas, should expect to confine growth to the lower portion or even below the indicated range for bank credit, particularly in instances where liquidity or capital ratios are below average. More rapidly growing banks should also evaluate their ability to support such growth without impairing liquidity or capital ratios.

The Federal Reserve and other federal bank regulatory agencies will carefully review patterns of loans and commitments at institutions that are experiencing growth in lending at or above the top of the range specified. Account will be taken of their own past experience and regional trends as well as the banks' capacity to finance their loan portfolios without straining capital or liquidity. Increases in loans by banks resulting in lower capital or liquidity ratios, particularly when the bank ratios are below peer groups, will be especially closely reviewed to assure their position is not weakened. In that connection, other regulatory authorities will be consulted as appropriate.

Individual institutions should adopt commitment policies that enable them to maintain adequate control over growth in loan totals and to assure funds are available to meet the priority needs specified below.

Qualitative Guidelines

The Board does not intend to set forth numerical guidelines for particular types of credit. However, banks are encouraged particularly:

(1) To restrain unsecured lending to consumers, including credit cards and other revolving credits. Credit for auto,

home mortgage and home improvement loans should not be subject to extraordinary restraint.

(2) To discourage financing of corporate takeovers or mergers and the retirement of corporate stock, except in those limited instances in which there is a clear justification in terms of production or economic efficiency commensurate with the size of the loan.

(3) To avoid financing of purely speculative holdings of commodities or precious metals or extraordinary inventory accumulation out of keeping with business operating needs.

(4) To maintain reasonable availability of funds to small businesses, farmers, and others without access to other forms of financing.

(5) To restrain the growth in commitments for backup lines in support of commercial paper.

(6) To maintain adequate flow of credit to smaller correspondent banks serving agricultural areas and small business needs and thrift institutions.

The terms and pricing of bank loans are expected to reflect the general circumstances of the marketplace. No specific guidelines or formulas are suggested. However, the Board does not feel it appropriate that lending rates be calculated in a manner that reflects the cost of relatively small amounts of marginal funds subject to the marginal reserve requirements on managed liabilities. Moreover, the Board expects that banks, as appropriate and possible, will adjust lending rates and other terms to take account of the special needs of small businesses, including farmers, and others.

Reporting

The Federal Reserve will closely monitor developments in all sectors of the credit markets and will ask that certain data and information be supplied by banks and others. The President, in activating the Credit Control Act of 1969, has provided authority for requiring such reports.

In the case of domestic banks with assets in excess of $1 billion, and for U.S. branches and agencies of foreign banks that have worldwide assets in excess of $1 billion, a monthly report will be requested. Monthly reports will also be requested on the business credit activities of domestic affiliates of bank holding companies with U.S. financial assets in excess of $1 billion. As will be noted, the bank reports include, apart from qualitative information, certain data on the movements in broad categories of loans and commitments, liquid asset holdings, and capital accounts. Certain data, including that on capital and liquidity, will be requested on a consolidated worldwide basis. Banks with less than $1 billion but more than $300 million in assets will report quarterly. Smaller institutions, while requested to observe the program, will not have special reporting requirements unless warranted by subsequent developments.

A group of large corporations will be requested to complete a brief monthly form about their activities in the commercial paper market, including the extent and usage of "backup" lines of credit at banks and their borrowing abroad. Finally, finance companies — including subsidiaries of bank holding companies — with more than $1 billion in loans outstanding to business borrowers will be requested to provide monthly reports concerning their business lending activities.

Consultative Arrangements

In instances warranted by trends in loans and commitments, Federal Reserve Bank officials in consultation with other federal bank regulatory agencies, will review with individual banks and others their progress in achieving and maintaining appropriate restraint on lending. In general, such consultations will be sought if:

(1) Bank or finance company lending is occurring at a pace that appears to be significantly in excess of the national objective, taking account of the location or past experience of the bank or other institution.

(2) Commitment policies appear to suggest the possibility of large subsequent increases in lending or exceptional expansion of commercial paper borrowing.

(3) Explanations of "takeover" or "speculative" financing contained in regular reports raise significant questions.

(4) The distribution of credit at an institution generally appears disproportionate in light of the qualitative guidelines above.

(5) Liquidity positions or capital ratios reflect developing strains, particularly in the case of institutions whose ratios are below peer group averages.

In the case of nonbanks, the Federal Reserve may also wish to hold informal discussions with such institutions if such discussions seem warranted by developments.

FEDERAL RESERVE press release

For immediate release May 22, 1980

Evaluation of recent banking and other credit data, including trends in consumer credit, indicate that current developments are well within the framework of the basic monetary and credit objectives of the Federal Reserve and the special measures of credit restraint established last March 14. The Federal Reserve is accordingly modifying and simplifying the administration of the special programs.

These actions do not represent any change in basic monetary policy as reflected in the targets for restrained growth in money and credit over 1980 that were developed early this year to help bring inflation under control.

The actions announced today are consistent with the intent to phase out those special and extraordinary measures only as conditions clearly permit. Therefore, the basic framework of the special March measures remain. These were established in part in conjunction with the action of the President to invoke certain provisions of the Credit Control Act of 1969.

Actions taken by the Board are:

--A reduction in the marginal reserve requirement on managed liabilities of large member banks and agencies and branches of foreign banks from 10 percent to 5 percent, and an upward adjustment of 7-1/2 percent in the base upon which the reserve requirement is calculated.

--A reduction in the special deposit requirement on managed liabilities of large nonmember institutions from 10 percent to 5 percent, together with a similar upward adjustment in their base.

--A decrease from 15 percent to 7-1/2 percent in the special deposit requirement that applies to increases in covered consumer credit.

--A decrease from 15 percent to 7-1/2 percent in the special deposit requirement that applies to increases in covered assets of money market mutual funds and other similar institutions.

--Modification of the Special Credit Restraint Program to ensure that more urgent credit needs are being met--such as those for small business, auto dealers and buyers, the housing market, agriculture and energy products and conservation--and to reduce reporting burdens as described in the attached letter to the Chief Executive Officer of commercial banks.

The lower marginal reserve requirement on the managed liabilities of member banks and foreign agencies and branches will apply to liabilities effective with the statement week of May 29-June 5. Effective that week also, the marginal reserve base will be increased by 7-1/2 percent above the base used to calculate the marginal reserve in the statement week of May 14-21. Declines in outstanding loans to foreigners will continue, as before, to reduce the base in subsequent weeks. The upward adjustment does not apply to the $100 million minimum base amount.

The same effective date and adjustment in base will apply to nonmember banks subject to the special deposit requirement on increases in managed liabilities.

The new special deposit requirement on covered consumer credit will be effective beginning with the average amount of credit outstanding in June, with the special deposit due July 24. For money market funds, the new requirement will be effective with assets in the week beginning June 16, and the deposit will be maintained in the week beginning June 30.

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Attachment

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

PAUL A. VOLCKER
CHAIRMAN

May 22, 1980

To the Chief Executive Officer of Banking Institutions:

Preliminary review of reports of large banks under the Special Credit Restraint Program, together with analysis of other banking data, now indicates that bank loans appear to be running comfortably within the 6 to 9 percent guideline set forth in the Special Credit Restraint Program. Moreover, the most recent data suggest the rate of growth has been at a significantly reduced pace, and some categories of loans, such as consumer loans, have actually been falling.

As you will recall, the 6-9 percent guideline was directly related to the objectives and targets set by the Federal Reserve to achieve restrained growth in the overall supply of money and credit during 1980 for the nation as a whole. While present trends appear fully consistent with reaching those goals, we recognize individual banks, or banks in some regions of the country, may face conditions that make it particularly difficult to meet the quantitative guidelines while fully respecting the qualitative guidelines. In that connection, the administration of the program will henceforth reflect the following criteria. These criteria are broadly consistent with the existing program, but are designed to provide for individual banks facing local conditions that may inhibit their ability to meet the overall objectives:

(1) Lending by small banks as a group (those under $100 million of deposits) has clearly been within the quantitative guidelines. Those banks should not feel under any special restraint in meeting the needs of their regular local customers, consistent with their individual capital and liquidity requirements. In particular, the program is not designed to exert restraint on agricultural, small business, home construction and improvement (including energy conservation), home mortgage, and auto-related credit. Small banks that find their lending exceeding the general guideline should refrain from extending their normal lending area or participating in larger credits to those with other potential sources of funds.

(2) Larger banks, consistent with the program, are also expected to treat loan requests from farmers, small businessmen, homebuilders, homebuyers (including home improvement and energy conservation loans), and auto dealers and buyers in a normal manner -- that is, consistent with the banks' credit standards and liquidity and capital needs. Customers particularly dependent on bank financing and enlarging production capability in response to urgent needs, such as energy, may warrant accommodation. If in meeting these needs, total loans appear to be rising to or above the 9% guideline, banks are expected to restrain loans to other borrowers, including those with access to other sources of funds and those outside the normal lending area. Banks respecting these priorities finding their total loans rising faster than consistent with the 9 percent guideline will be expected to demonstrate that their policies are consistent with these priorities in their reports and reviews with the regional Federal Reserve Banks. Banks will be justified in exceeding the quantitative guidelines when such a demonstration can be made.

(3) All banks are requested, as before, to avoid use of available credit resources to support essentially speculative uses of funds, or to finance transactions such as takeovers or mergers that can reasonably be postponed and that do not contribute to eonomic efficiency or productivity.

(4) The Board will continue to monitor the program through special reports and evaluation of the continuous flow of data on bank loans that it obtains through its regular reporting channels. To reduce the administrative burden of the program, however, the number of special reports will be reduced. Reports from large banks will henceforth be obtained on a bi-monthly rather than a monthly basis. Reports from large corporate borrowers will be discontinued. The first quarterly report from intermediate-size banks will be simplified, and the need for any further report will be considered after that check point is passed. As before, no reports will be required from small banks.

Sincerely,

Paul A Volcker

Paul A. Volcker

FEDERAL RESERVE press release

July 3, 1980

For immediate release

The Federal Reserve Board today announced plans to complete the phase-out of the special measures of credit restraint that had been put in place, or reinforced, on March 14 of this year.

The special measures were designed to supplement, temporarily, more general measures of credit and monetary control, and recent evidence indicates that the need for those extraordinary measures has ended. For the year to date, credit expansion, particularly at banks, is clearly running at a moderate pace. In recent months, there has been apparent contraction in consumer borrowing, indications are that anticipatory and speculative demands for credit have subsided, and funds have been in more ample supply.

While the special conditions necessitating the extraordinary credit restraints are no longer present, the Board emphasized that its general goals of achieving restrained growth in money and credit aggregates are unchanged. Those continuing goals are closely related to its concern with further reduction of inflationary pressures in the economy.

The Board previously, on May 22, had halved the special deposit requirements in connection with the credit restraint program and had modified the guidelines for the special program for restraining bank credit growth.

Today, the Board scheduled completion of the phase-out by taking the following measures:

--Elimination of the remaining 5 percent marginal reserve requirement on managed liabilities of large banks and agencies and branches of foreign banks. This action applies to managed liabilities beginning July 10, for reserves required beginning July 24. In addition, the Board eliminated, effective the same date, the 2 percent supplementary reserve requirement applicable to member banks on large time deposits. This requirement had been initiated in November 1978.

--Elimination of the remaining 7-1/2 percent special deposit requirement that applies to increases in covered consumer credit, effective for covered credit extended in June and thereafter. Thus, no further special deposits will be required after the present deposit maintenance period ends on July 23. To permit orderly implementation of changes now in process and to assure adequate notice of such changes to credit users, the Board's rule permitting creditors to modify the terms of credit accounts will remain in effect for notices mailed only on or before September 5.[1/]

--Elimination of the remaining 7-1/2 percent special deposit requirement that applies to increases in covered assets of money market mutual funds and other similar institutions. This action applies to covered assets beginning July 28, and hence no special deposits will be required beginning August 11.

--Phase-out of the Special Credit Restraint Program under which banking institutions and finance companies were asked to limit domestic loan growth to a range of 6 to 9 percent in 1980. Available data for the first five months of this year indicate that bank loans to domestic borrowers have increased at around a 3 percent annual rate. Banking institutions with $300 million or

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[1/] Under the consumer credit restraint program, to make certain changes in terms of accounts, a creditor must send a 30-day advance notice explaining the changes and giving the consumer the option of paying down the existing balance according to the original terms. Subsequent use of the account by the consumer is deemed to be acceptance of the new terms.

more deposits will be expected to complete reports (either the quarterly report or the monthly report for the larger institutions) due under this program July 10 for data as of June 30. After those reports are received, discussions will be held with individual banks to review experience with the special program.

In phasing out the aggregate 6-9 percent guideline for individual institutions, the Board feels that normal competitive and market incentives can again be relied upon to assure the flow of credit consistent with normal banking standards, and that qualitative guidelines are therefore no longer appropriate. However, the Board remains concerned over the volume of credit that appears to have flowed to essentially speculative purposes in the past, and is considering the need for additional means of monitoring such developments in the future.

The Board's orders in these matters are attached.

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APPENDIX B

Special Credit Restraint Program
Answers to Questions

FEDERAL RESERVE press release

For immediate release March 26, 1980

The staff of the Federal Reserve Board has supplied the attached answers to frequently asked questions it has received concerning the Board's anti-inflation program announced March 14.

Other sets of questions and answers will be issued as they become available.

Q & A -- 3/26/80

THE SPECIAL CREDIT RESTRAINT PROGRAM -- Page 1

1. Does the Special Credit Restraint Program apply to sales of federal funds?

Answer: No.

2. Are loans to non-U.S. residents covered by the guidelines under the Special Credit Restraint Program?

Answer: Loans by domestic or foreign offices to non-U.S. residents are not specifically covered. However, excessive growth in such loans may have an undesirable effect on the liquidity and/or capital positions of the bank and the Federal Reserve intends to monitor such positions carefully.

3. Will the reporting forms be revised to add, to the statistical information requested of banking organizations, a memo item for loans to foreigners?

Answer: It has been decided not to revise the forms for the additional item. In their contacts with banks, Reserve Banks will suggest that, when a respondent has a special situation regarding loans to foreigners (e.g., a large increase in total loans that mostly reflects loans to foreigners), this fact should be called to the attention of the Reserve Bank by noting it in the space provided for explanations (section D).

4. To what period does the limitation on loan growth "in 1980" refer?

Answer: It refers to the period from December 1979 to December 1980.

5. The reporting forms do not ask for the December 1979 "base period." How will we obtain these base-period levels?

Answer: For almost all respondents subject to the lending constraint, data for the December 1979 base period are generally available from reports they file regularly with the Federal Reserve or with one of the other bank supervisory agencies.

6. Does "December 1979" mean December 31?

Answer: In order to avoid the distortions in base period levels that could arise from calculating them as of a single day, an average for the month of December should be used to the extent permitted by available data. For weekly reporting banks, an average of the four Wednesdays in December 1979 seems appropriate. For businesses (e.g. finance companies) from which we have been receiving end-of-month reports, November and December figures should be averaged. For respondents such as nonmember banks, however, December 31 data will have to be used for the base period.

7. Is it essential that reporting of data by bank holding companies be as of the last Wednesday of the month, or are data as of the last business day of the month acceptable?

Answer: Data as of the last business day are entirely acceptable, especially if this reduces the reporting burden on respondents.

8. Should the statistical information on loan commitments outstanding include lines or just commitments? -- Total amounts or just the unused portions?

Answers: The figures reported for loan commitments should be unused confirmed lines plus unused commitments, to both nonfinancial and nonbank financial business customers.

THE SPECIAL CREDIT RESTRAINT PROGRAM -- Page 3*

9. Are any classes of bank loans (such as loans to small business) to U.S. residents "exempt" or excluded from the 6 to 9 percent quantitative guideline for growth in bank loans in the Special Credit Restraint Program?

Answer: No. The qualitative objectives of the program call upon banks and other lenders to ensure that flows of credit to small business, farmers, homebuyers, smaller correspondent banks and others as stipulated in the Program are maintained. However, growth in these loan categories are included in the overall quantitative guidelines relating to lending. Consequently, where necessary, individual banks are expected to exercise special restraint on loans to large business customers or others that have access to other sources of funds so that credit to groups requiring special attention can be maintained. The guidelines thus apply to overall loan growth; the special categories are not "exempt" in judging overall growth, but the restraint should fall on other sectors.

10. How can a bank that is already high in or above the 6 to 9 range cope with takedowns of legally binding commitments that would push the bank's overall loans over or further beyond the 9 percent limit?

Answer: As a first step, banks should review existing commitments carefully to determine which are, in fact, legally binding. Also, banks in such a position should attempt aggressively to encourage prospective borrowers to postpone such takedowns where possible and/or to consider alternate sources of funding. If these options are not realistic and the loans are made, the Federal Reserve would fully expect that such a bank would be extraordinarily careful about making new commitments, and that it would not accommodate such loans by reducing credit to small business, homebuyers, farmers and other similar customers. Moreover, in these circumstances, the Federal Reserve's attitude toward the bank's performance will be importantly influenced by the bank's liquidity and capital position relative to that of its peers.

11. How firm is the 6 to 9 percent limit on loan growth? Under what circumstances will faster growth be acceptable?

Answer: In the current economic and market circumstances, the 6 tp 9 percent range is a firm guideline for the December 1979-December 1980 period. Banks should judge current trends in the light of that yearly target. It is recognized that loans or commitments made during the first two months of the year, seasonal peaks in lending (as, for example, around tax dates), exceptionally strong local growth, or other particular factors might cause some banks temporarily to exceed a path consistent with the guideline. In such cases, special consultations will be held with the regional Federal Reserve Bank in which the bank(s) should be prepared to explain and justify the circumstances surrounding the departure and to discuss plans for slowing the pace of lending, particularly in areas not subject to special treatment, so as to move back within the range. One important element in such special consultations will be the lending pattern of the bank in relation to its capital and liquidity position.

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*Questions and answers were last previously supplied under this heading in the set of questions and answers dated March 26.

12. Does the 6 to 9 percent growth limit apply equally to the credit extended by nonbank subsidiaries of bank holding companies?

Answer: Yes, the general limitation on loan growth does apply to the bank and nonbank subsidiaries of bank holding companies. The Federal Reserve is mindful of the possibility that each unit in a bank holding company may not experience the same rate of credit expansion. In these circumstances the Federal Reserve will look at the aggregate rate of credit expansion by the overall holding company as well as the performance of individual reporting units within the holding company structure.

13. Does the 6 to 9 percent growth limit apply to the credit extended by finance companies that are not affiliated with bank holding companies?

Answer: Finance companies are expected to respect the overall intent of the program. Consistent with the framework of the program, no special restraint is suggested for consumers and small business lending, which would include auto dealers with credit lines of $1.5 million or less. Lending to larger businesses should be reduced to accommodate any increases in consumer and automobile paper so that the overall growth can stay within the guideline. The Federal Reserve recognizes that in some instances the firm's customer base and/or seasonal or cyclical patterns of lending by such finance companies may require evaluation on a case by case basis. In such instances, finance companies should, in their subsequent reporting to their respective Federal Reserve Banks, provide appropriate information bearing on such circumstances.

14. Page 1 of the Fed press release states that special efforts will be made to maintain credit for farmers and small businessmen, including accommodation of the needs of correspondent banks serving such customers. What is the nature of these special efforts?

Answer: The Federal Reserve expects that individual banks without special lending and credit availability programs will design appropriate programs to maintain the flow of such credit and promptly put them into effect. These programs should reflect the nature of that bank's business, its existing customer base, and other appropriate circumstances. While the nature and substance of such programs must and should be determined by the individual banks, the banks are asked to inform their Federal Reserve Bank of their programs. Moreover, bank examiners will monitor the implementation of these special programs as part of the usual examination process.

15. The program states that account will be taken of a bank's capacity to finance its loan portfolio without straining capital or liquidity. How will this be done?

Answer: The Federal Reserve is mindful of the fact that both the capital and liquidity positions of some banks are lower than may be desirable over time and that some banks are therefore not as well equipped as others to absorb increases in lending. In view of this, and in the light of the continuing interest of the Federal Reserve and the other federal bank regulatory agencies in promoting stronger capital and liquidity positions in the banking industry, the Federal Reserve will be especially sensitive to those banks with loan growth in the upper area of, or temporarily above, the guideline range at the expense of further declines in already relatively low capital and liquidity positions. In some instances, capital and liquidity considerations may require special consultations even when a bank's loan growth is well within the specified range.

16. Are export loans included in the total of loans subject to the 6 to 9 percent growth limitation?

Answer: They are. But the Board would not want banks to reduce the availability of export loans in order to make less desirable types of loans. Any bank that exceeds the growth limit because of export loans should note that fact in Section D of its report.

17. Are extensions of credit by Edge Act subsidiaries included in the 6-9 percent guideline?

Answer: Loans by Edge Act subsidiaries to U.S. addressees are to be included in total loans and leases to U.S. addressees by banks, branches and agencies, and bank holding companies. The 6-9 percent growth limitation applies to this measure of bank lending. Thus, Edge Corporations are not exempt from the growth limit on bank loans.

8. If a corporation reporting on form FR 2062e does not have timely, or any, ecords for some components of the corporation's indebtedness to non-U.S. ntities--in particular, debt initially placed in the United States through hird parties, and open-book credit--and is unable even to make a "good faith" stimate of such components, how should these items be reported?

nswer: It is not necessary for reporting corporations to determine the amount f debt issued directly to U.S. lenders or raised through U.S. dealers or other .S. third parties that is now held by non-U.S. entities. No part of the outtanding amounts of such debt should be reported in item A2 of form FR 2062e. owever, a shift toward placing debt abroad through U.S. third parties for other han normal business reasons would, of course, not be consistent with the spirit f the Special Credit Restraint Program.

Reporting corporations are expected to include open-book credit (trade otes and accounts payable) in reporting their indebtedness to non-U.S. entities, f this is feasible. If data on net payables to non-U.S. subsidiaries and ffiliates and/or gross payables to other non-U.S. entities are available, but not n a timely basis, the corporation should consult with its Reserve Bank as to hether to include this component with a lag or to make some other adjustment. If here is no practical way for the corporation to develop data on open-book credit wed to non-U.S. entities, this component may be omitted from item A2 but the eserve Bank should be informed of the omission. In any event, open-book credit--nd all other components as well--should be reported on a consistent basis from onth to month.

9. May data be reported as of some day other than the one called for on the eporting forms--that is, other than the last Wednesday of the month for comercial banks, branches and agencies of foreign banks and bank holding companies, nd the last business day of the month for all other reporting entities?

nswer: It is not necessary to develop data as of the stipulated day if records or all or part of the reporting entity are generally available only as of some ther day during the month. However, data should be reported on a consistent basis rom month to month, and the date (or dates, in the case of mixed reporting) to hich they refer should be noted on the reporting form.

0. At least part of the data for a bank's foreign offices that are required to omplete the bank's (or holding company's) Special Credit Restraint Program report ormally do not become available to the U.S. parent in time to permit filing the eport with the Reserve Bank by the stipulated deadline. Is an extended deadline vailable? May some or all data be reported with a one-month lag? For example or the April report, may the "current month" in fact be March either for some items n their entirety, or for the foreign-office component of all items?

swer: Reporting problems of this kind should be discussed with the Reserve Bank, nce they will be considered on a case-by-case basis. In general, extension f the reporting deadline by a few days is preferable to lagged reporting, pecially for data relating to loans. In cases where lack of timely data for foreign offices relates only to the liquidity and capital measures, reporting with a one-month lag of items affected by the foreign data will be considered. Any such adjustments in reporting must be approved by the Reserve Bank in advance.

21. Are industrial revenue bonds to be included in total loans and leases subject to the 6 to 9 percent growth limitation?

Answer: No. Industrial revenue bonds are defined as investments, not loans. However, Reserve Banks should be alert to the possibility of a bank's arranging an industrial revenue bond financing as a substitute for the commercial and industrial loan the bank would have made in the absence of the Special Credit Restraint Program. Any bank that appears to be acquiring an unusually large amount of industrial revenue bonds should be asked for an explanation.

22. Are factoring receivables included in total loans subject to the 6 to 9 percent limitation?

Answer: Since the instructions to the Call Report appear to define such accounts as loans, they should be defined as loans for purposes of the Special Credit Restraint Program.

APPENDIX C

Special Credit Restraint Program
Statistical Tables

Table IA1
Credit Demands and Loan Policies

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

	March	April
	(number of respondents)	
	170	170
Current strength of total private credit demands from U.S. addressees, as compared with the situation generally prevailing during February 1980 and taking account of seasonal patterns.		
Significantly greater	26	5
Essentially unchanged	126	104
Significantly less	18	61
Applications for commercial and industrial loans or loan commitments to meet basic credit demands for normal operations, as compared with the same month in recent years.		
Significantly larger	63	19
Essentially unchanged	83	95
Significantly less	24	56
Proportion of such applications approved.		
Significantly larger than usual	17	3
Essentially unchanged	124	133
Significantly smaller than usual	29	34
Applications for commercial and industrial loans to meet basic and emerging needs for smaller businesses, as compared with the same month in recent years.		
Significantly larger	4	2
Essentially unchanged	131	116
Significantly less	35	52
Proportion of such applications approved.		
Significantly larger than usual	2	0
Essentially unchanged	155	151
Significantly smaller than usual	13	19

Table IA1 (cont'd)

			March	April
Commercial and industrial loans for purely financial activities.				
Requests:	Yes		80	71
	No		90	99
Approvals:	Yes		38	34
	No		132	136
Commitment takedowns:		Yes	32	23
		No	138	147
Loans to business customers for speculative purposes.				
Requests:	Yes		47	41
	No		123	129
Approvals:	Yes		9	5
	No		161	165
Commitment takedowns:		Yes	7	4
		No	163	166
Applications for commercial and industrial loans or loan commitments for non-U.S. affiliates of U.S. firms, as compared with the same month in recent years.				
Significantly larger			3	1
Essentially unchanged			161	158
Significantly less			6	11
Proportion of such applications approved.				
Significantly larger than usual			0	0
Essentially unchanged			163	161
Significantly smaller than usual			7	9

Table III
Selected Financial Data
(Amounts outstanding, in billions of dollars)

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

	February		March		April	
	1979	1980	1979	1980	1979	1980
Total loans and investments	453.5	514.0	456.1	514.9	461.4	515.2
Total loans	346.6	401.8	348.3	403.6	353.7	403.4
Total C & I loans	135.8	159.4	138.2	161.9	142.0	159.0
To U.S. addressees	126.9	150.5	129.4	152.9	133.5	152.5
To smaller businesses	29.0	32.2	29.7	32.3	30.6	32.7
Real estate loans, resid. prop.	50.6	60.7	51.5	61.5	51.8	61.6
Agricultural loans	4.6	5.1	4.7	5.2	4.8	5.2
All other loans	155.6	175.3	153.8	174.8	155.0	174.2
Lease financing receivables	6.0	8.5	6.2	8.7	6.3	8.8
U.S. customers' liability on acceptances	8.7	13.1	9.1	13.6	8.5	13.2
Loan commitments	228.1	293.3	247.8	336.0	249.4	341.1
C & I loans by foreign offices to U.S. addressees	4.0	5.1	4.3	5.0	4.3	5.2
Total liquid assets	171.7	193.2	175.6	187.5	175.2	197.3
Total discretionary liabilities	423.1	505.7	430.9	502.4	429.7	506.7
Total assets	867.2	994.6	880.1	1001.6	893.2	1011.7
Total equity capital	39.4	46.7	42.7	46.9	43.0	47.9
Total loans and leases	338.4	398.8	343.0	401.9	349.1	403.5

	December 1979	March 14, 1980
Memo: Total loans and leases to U.S. addressees	398.1	xxxxxx
Loan commitments to U.S. addressees	294.1	328.8

Table IB2
Selected Financial Data
(Changes in amounts outstanding, in billions of dollars)

U.S. Commercial Banks
Assets $1 Billion or more

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Total loans and investments	60.5	58.8	53.9
Total loans	55.2	55.3	49.7
Total C & I loans	23.6	23.7	16.9
To U.S. addressees	23.6	23.4	19.0
To smaller businesses	3.2	2.6	2.2
Real estate loans, resid. prop.	10.1	10.1	9.8
Agricultural loans	0.5	0.4	0.4
All other loans	19.7	21.0	19.2
Lease financing receivables	2.4	2.5	2.4
U.S. customers' liability on acceptances	4.4	4.4	4.7
Loan commitments	65.2	87.1	91.7
C & I loans by foreign offices to U.S. addressees	1.1	0.7	0.9
Total loans and leases	60.3	59.0	54.3

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Total loans and investments	2.6	0.9	5.3	0.3
Total loans	1.7	1.8	5.4	-0.2
Total C & I loans	2.5	2.5	3.8	-2.9
To U.S. addressees	2.6	2.4	4.1	-0.3
To smaller businesses	0.6	0.1	0.1	0.3
Real estate loans, resid. prop.	0.9	0.8	1.2	0.1
Agricultural loans	0.1	0.1	0.2	-0.0
All other loans	-1.7	-0.5	1.1	-0.6
Lease financing receivables	0.1	0.2	0.2	0.1
U.S. customers' liability on acceptances	0.4	0.4	-0.7	-0.4
Loan commitments	19.7	40.6	1.6	7.2
C & I loans by foreign offices to U.S. addressees	0.3	-0.1	0.0	0.2
Total loans and leases	4 5	3.2	6.1	-1.5

	Change from December 1979		
	February	March	April
Total loans and leases to U.S. addressees	0.6	3.8	5.3
Loan commitments to U.S. addressees	-0.8	39.9	47.1

Table IB3
Selected Financial Data
(Percent changes in amounts outstanding)

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Total loans and investments	13.3	12.9	11.7
Total loans	15.9	15.9	14.1
Total C & I loans	17.4	17.1	11.9
To U.S. addressees	18.6	18.1	14.2
To smaller businesses	10.9	8.9	7.1
Real estate loans, resid. prop.	20.0	19.6	18.9
Agricultural loans	10.5	9.5	7.6
All other loans	12.7	13.6	12.4
Lease financing receivables	40.6	40.1	38.6
U.S. customers' liability on acceptances	50.8	48.7	55.6
Loan commitments	28.6	34.8	36.8
C & I loans by foreign offices to U.S. addressees	27.8	16.3	20.8
Total loans and leases	17.8	17.2	15.6

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Total loans and investments	0.6	0.2	1.2	0.1
Total loans	0.5	0.4	1.5	-0.0
Total C & I loans	1.8	1.6	2.7	-1.8
To U.S. addressees	2.0	1.6	3.1	-0.2
To smaller businesses	2.2	0.4	2.9	1.2
Real estate loans, resid. prop.	1.7	1.4	0.7	0.2
Agricultural loans	2.0	1.1	1.3	-0.4
All other loans	-1.1	-0.3	0.8	-0.3
Lease financing receivables	2.4	2.1	2.6	1.5
U.S. customers' liability on acceptances	5.1	3.6	-7.3	-3.0
Loan commitments	8.6	13.9	0.6	2.2
C & I loans by foreign offices to U.S. addressees	6.8	-2.9	0.8	4.7
Total loans and leases	1.3	0.8	1.8	0.4

	Change from December 1979		
	February	March	April
Total loans and leases to U.S. addressees	0.2	1.0	1.3
Loan commitments to U.S. addressees	-0.3	13.6	16.0

Table 284
Loans, by Type
(Percentage distribution)

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

Type of loan	February 1979	February 1980	March 1979	March 1980	April 1979	April 1980
Total loans	100.0	100.0	100.0	100.0	100.0	100.0
Total C & I loans	39.2	39.7	39.7	40.1	40.2	39.4
To U.S. addressees	36.6	37.4	37.2	37.9	37.7	37.8
To smaller businesses	8.4	8.0	8.5	8.0	8.6	8.1
Real estate loans, resid. prop.	14.6	15.1	14.8	15.2	14.7	15.3
Agricultural loans	1.3	1.3	1.4	1.3	1.4	1.3
All other loans	44.9	43.6	44.2	43.3	43.8	43.2
Total C & I loans	100.0	100.0	100.0	100.0	100.0	100.0
To U.S. addressees	93.5	94.4	93.7	94.4	94.0	96.0
To smaller businesses	21.4	20.2	21.5	20.0	21.3	20.6

Table IB5
Relationship of Unused Loan Commitments to Total Loans and Leases

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

	1979	1980		
	December	February	March	April
		(percent)		
Unused commitments/ Total loans and leases	73.9	73.6	83.1	84.6

Table I86
Liquidity and Capital Ratios
(Percent)

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

Ratio	February		March		April	
	1979	1980	1979	1980	1979	1980
Liquid assets/Total assets	19.8	19.4	20.0	18.7	19.6	19.5
Discretionary liabilities/Total assets	48.8	50.8	49.0	50.2	48.1	50.1
Liquid assets minus disc. liab./Total assets	-29.0	-31.4	-29.0	-31.4	-28.5	-30.6
Liquid assets/Discretionary liabilities	40.6	38.2	40.7	37.3	40.8	38.9
Total equity capital/Total assets	4.5	4.7	4.9	4.7	4.8	4.7

Table ICI
Selected Financial Data
(Distributions of individual respondent percent changes in amounts outstanding)

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

	Change from year-ago month (quartiles)								
	February			March			April		
	1	2	3	1	2	3	1	2	3
Total loans & investments	4.8	10.1	15.6	3.8	9.4	15.1	2.9	7.6	13.2
Total loans	6.8	11.6	17.5	5.8	11.5	16.9	3.9	9.1	15.4
Total C & I loans	2.2	11.7	21.0	2.1	11.1	22.3	1.2	8.8	18.4
To U.S. addressees	3.3	12.0	22.4	2.2	11.5	22.6	1.6	9.4	16.9
To smaller businesses	0.4	8.4	21.3	-0.6	6.5	19.2	-2.1	4.9	16.6
Real estate loans, resid. prop.	5.1	13.3	26.0	4.8	12.3	27.3	3.8	12.9	24.9
Agricultural loans	-22.8	4.0	24.3	-27.5	0.6	21.1	-25.9	-2.5	24.0
All other loans	2.2	9.0	16.4	3.1	9.0	15.8	0.3	7.6	14.1
Lease financing receivables	-5.3	15.3	40.6	-5.1	16.6	44.4	-5.4	14.9	39.7
U.S. customers' liability on acceptances	-18.8	43.2	143.7	-4.5	53.3	136.6	-2.5	71.3	199.2
Loan commitments	8.9	18.4	30.7	9.2	18.4	30.7	8.4	18.6	34.3
C & I loans by foreign offices to U.S. addressees	-29.3	14.9	65.6	-33.3	19.6	81.5	-20.4	19.9	103.9
Total liquid assets	-12.0	4.6	27.1	15.0	3.8	25.1	-12.3	10.9	40.9
Total discretionary liabilities	4.1	16.4	29.4	2.8	15.0	26.9	1.8	14.4	28.8
Total assets	5.2	10.3	16.0	6.7	11.0	16.7	4.6	10.7	16.7
Total equity capital	5.3	9.5	12.2	5.4	9.1	11.5	5.2	9.1	12.0
Total loans and leases	7.0	11.9	18.5	5.6	11.4	18.8	3.9	9.5	15.4

	Change from preceding month (quartiles)											
	March 1979			March 1980			April 1979			April 1980		
	1	2	3	1	2	3	1	2	3	1	2	3
Total loans & investments	-0.6	0.6	1.7	-1.0	0.0	1.4	0.0	1.3	2.8	-1.6	-0.1	1.5
Total loans	-0.4	0.9	1.9	-0.7	0.3	1.4	0.4	1.3	2.8	-1.5	-0.1	1.0
Total C & I loans	-0.1	1.9	4.0	-1.0	0.7	3.4	0.3	2.2	4.2	-2.2	-0.1	2.5
To U.S. addressees	0.1	2.3	4.3	-0.9	1.0	3.8	0.4	2.6	4.6	-2.2	-0.3	2.6
To smaller businesses	-0.4	1.3	4.1	-1.2	0.4	2.6	-0.4	1.9	5.7	-3.5	-0.5	3.4
Real estate loans resid. prop.	-0.2	0.9	2.0	-0.5	0.3	1.3	-0.2	0.9	2.9	-1.2	0.4	2.3
Agricultural loans	-4.3	0.6	6.5	-3.0	0.0	3.8	-6.6	0.4	6.0	-8.9	-0.9	4.1
All other loans	-2.4	-0.1	1.7	-1.9	-0.3	1.2	-1.3	1.1	3.0	-2.8	-0.8	1.4
Lease financing receivables	-0.7	0.0	2.0	-0.8	0.0	2.1	-1.2	0.2	3.0	-1.3	-0.0	2.3
U.S. customers' liability on acceptances	-12.7	1.4	19.7	-12.3	2.5	21.5	-16.3	-0.9	13.8	-15.8	1.6	31.0
Loan commitments'	-0.8	1.4	3.8	0.0	2.3	5.6	-3.0	0.8	3.5	-2.2	0.3	3.3
C & I loans by foreign offices to U.S. addressees	-5.6	0.0	6.1	-10.3	0.0	5.3	-4.4	0.0	18.7	-10.2	0.0	7.3
Total liquid assets	-11.3	-0.8	10.4	-10.6	0.7	11.1	-9.2	0.2	13.5	-9.7	2.6	20.7
Total discretionary liab.	-3.0	0.6	6.2	-4.6	-0.4	3.7	-3.8	1.4	6.8	-4.3	0.0	5.9
Total assets	-2.2	-0.3	2.0	-1.2	0.4	2.8	0.4	2.3	4.4	-0.4	1.6	3.9
Total equity capital	-0.3	0.8	1.5	-0.5	0.4	1.1	-0.0	0.8	1.3	0.0	1.0	1.9
Total loans and leases	-0.1	0.9	2.0	-0.6	0.3	1.6	0.4	1.6	3.3	-1.5	0.0	1.1

Table IC1 (cont'd)

	Change from December 1979 (quartiles)								
	February			March			April		
	1	2	3	1	2	3	1	2	3
Loan commitments to U.S. addressees	0.0	2.6	7.1	1.6	5.3	10.7	0.0	6.5	13.5
Total loans and leases to U.S. addressees	-2.0	-0.1	1.5	-1.7	0.1	2.1	-2.1	0.2	2.1

	Change from December 1979	February	March	April
	(percent)	(Number of respondents)		
Total loans and leases to U.S. addressees	Actual:			
	less than 0.0	87	76	78
	0.0-5.99	82	87	86
	6.00-9.00	1	4	3
	over 9.00	0	3	3
	Annualized:			
	less than 0.0	87	76	78
	0.0-5.99	24	39	44
	6.00-9.00	16	15	18
	over 9.00	43	40	30

Table IC2
Loans, by Type
(Individual respondent data)

U.S. Commercial Banks
Assets $1 Billion or more

All Federal Reserve Districts

(quartiles)

Type of loan	March 1979			March 1980			April 1979			April 1980		
	1	2	3	1	2	3	1	2	3	1	2	3
	Percent of total loans											
C & I loans	28.0	35.3	44.6	27.7	36.8	44.4	29.1	36.1	43.9	27.9	37.1	44.6
To U.S. add.	26.6	33.7	43.5	26.4	35.0	42.9	27.7	34.4	43.6	26.7	34.8	44.1
To smaller bus.	4.2	10.3	17.3	4.8	9.9	17.3	4.2	9.9	17.5	4.7	9.9	17.2
Real estate, resid.	7.0	14.7	23.1	7.7	14.6	23.2	7.2	14.7	22.4	7.8	15.0	23.2
Agricultural	0.0	0.4	1.3	0.0	0.4	1.4	0.0	0.4	1.3	0.0	0.3	1.4
All other	40.6	45.7	52.3	39.8	45.4	51.2	40.3	45.9	53.3	39.6	45.4	51.4
	Percent of C & I loans											
C & I to U.S. add.	94.4	98.3	100.0	94.7	98.1	100.0	94.3	98.1	100.0	94.4	98.3	100.0
To smaller bus.	11.6	29.3	54.8	12.5	30.0	55.0	10.8	28.9	54.2	11.4	30.8	56.6

Table IC3
Relationship of Unused Loan Commitments to Total Loans and Leases
(Distribution of individual respondent ratios)

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

	1979						1980					
	December			February			March			April		
	(quartiles)											
	1	2	3	1	2	3	1	2	3	1	2	3
Unused commitments (percent of total loans and leases)	31.7	52.0	86.0	33.3	53.0	91.0	33.5	54.2	94.3	34.1	56.4	97.3

Table IC4
Liquidity and Capital Ratios
(Distribution of individual respondent ratios)

U.S. Commercial Banks
Assets $1 Billion or More

All Federal Reserve Districts

Ratio	Quartile	February 1979	February 1980	March 1979	March 1980	April 1979	April 1980
		(percent)					
Liquid assets/Total assets	1	8.6	7.4	8.5	7.6	8.2	8.0
	2	12.9	13.0	13.1	12.7	13.1	12.7
	3	20.3	18.6	20.7	18.0	19.0	19.1
Discretionary liabilities/ Total assets	1	25.4	27.1	26.6	25.9	25.5	25.9
	2	34.9	37.0	34.8	37.0	34.3	36.8
	3	45.8	48.4	46.1	49.0	46.3	49.7
Liquid assets minus disc. liab./Total assets	1	-28.4	-32.8	-29.6	-32.6	-30.0	-32.8
	2	-20.3	-22.9	-21.5	-23.7	-20.6	-22.7
	3	-12.7	-14.1	-12.3	-14.7	-13.5	-14.0
Liquid assets/Discretionary liabilities	1	28.7	25.2	27.7	24.1	28.4	25.4
	2	39.0	36.3	38.5	35.7	38.6	35.9
	3	54.4	50.0	54.5	50.8	54.8	53.4
Total equity capital/ Total assets	1	5.0	5.1	5.1	5.0	5.0	4.9
	2	5.9	5.8	5.9	5.8	5.8	5.7
	3	6.8	6.8	6.8	6.7	6.7	6.6

Table IIA1
Credit Demands and Loan Policies
U.S. Branches and Agencies of Foreign Banks
All Asset Sizes

All Federal Reserve Districts

	March	April
	(number of respondents)	
	139	139
Current strength of total private credit demands from U.S. addressees, as compared with the situation generally prevailing during February 1980 and taking account of seasonal patterns.		
Significantly greater	23	8
Essentially unchanged	110	118
Significantly less	6	13
Applications for commercial and industrial loans or loan commitments to meet basic credit demands for normal operations, as compared with the same month in recent years.		
Significantly larger	34	18
Essentially unchanged	98	110
Significantly less	7	11
Proportion of such applications approved.		
Significantly larger than usual	8	3
Essentially unchanged	116	118
Significantly smaller than usual	15	18
Applications for commercial and industrial loans to meet basic and emerging needs for smaller businesses, as compared with the same month in recent years.		
Significantly larger	5	3
Essentially unchanged	127	129
Significantly less	7	7
Proportion of such applications approved.		
Significantly larger than usual	3	1
Essentially unchanged	131	132
Significantly smaller than usual	5	6

Table IIA1 (cont'd)

		March	April
Commercial and industrial loans for purely financial activities.			
Requests:	Yes	19	13
	No	120	126
Approvals:	Yes	1	2
	No	138	137
Commitment takedowns:	Yes	7	2
	No	132	137
Loans to business customers for speculative purposes.			
Requests:	Yes	5	3
	No	134	136
Approvals:	Yes	0	0
	No	139	139
Commitment takedowns:	Yes	2	0
	No	137	139
Shifts out of United States, during the current month, of commercial and industrial lending to U.S. addressees.			
Rebooking of maturing loans offshore			
	Yes	4	3
	No	135	136
Sale of loans to non-U.S. offices of foreign parent			
	Yes	0	2
	No	139	137
Booking of new loans abroad rather than in United States			
	Yes	1	2
	No	138	137
Applications for foreign-booked commercial and industrial loans or loan commitments for U.S. addressees, as compared with the same month in recent years.			
Significantly larger		6	2
Essentially unchanged		129	133
Significantly less		4	4
Proportion of such applications approved.			
Significantly larger than usual		1	0
Essentially unchanged		134	133
Significantly smaller than usual		4	6

Table IIA1 (cont'd)

	March	April
Applications for foreign-booked commercial and industrial loans or loan commitments for non-U.S. affiliates of U.S. firms, as compared with the same month in recent years.		
Significantly larger	**1**	**0**
Essentiallly unchanged	**134**	**135**
Significantly less	**4**	**4**
Proportion of such applications approved.		
Significantly larger than usual	**0**	**1**
Essentially unchanged	**134**	**133**
Significantly smaller than usual	**5**	**5**

Table IIB2
Selected Financial Data
(Changes in amounts outstanding, in billions of dollars)

U.S. Branches and Agencies of Foreign Banks
All Asset Sizes

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Total loans and investments	7.7	19.3	17.4
Total loans	18.5	18.4	17.4
Total C & I loans	10.8	10.6	9.3
To U.S. addressees	7.0	7.3	6.2
To smaller businesses	0.2	0.2	0.2
Real estate loans, resid. prop.	0.0	0.0	0.0
Agricultural loans	--	--	--
All other loans	7.7	7.7	8.0
Lease financing receivables	--	--	--
U.S. customers' liability on acceptances	1.0	0.8	0.8
Loan commitments	26.8	31.2	29.9
Total loans and leases	14.0	15.6	12.4

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Total loans and investments	-8.5	3.0	0.1	-1.7
Total loans	2.9	2.8	0.4	-0.7
Total C & I loans	1.6	1.4	-0.1	-1.5
To U.S. addressees	0.7	0.9	-0.1	-1.2
To smaller businesses	0.0	0.0	0.0	0.0
Real estate loans, resid. prop.	0.0	0.0	0.0	0.0
Agricultural loans	--	--	--	--
All other loans	1.3	1.4	0.5	0.8
Lease financing receivables	--	--	--	--
U.S. customers' liability on acceptances	0.4	0.2	0.1	0.1
Loan commitments	0.7	5.1	1.9	0.6
Total loans and leases	-0.1	1.5	0.7	-2.6

Table IIB1
Selected Financial Data
(Amounts outstanding, in billions of dollars)

U.S. Branches and Agencies of Foreign Banks
All Asset Sizes

All Federal Reserve Districts

	February		March		April	
	1979	1980	1979	1980	1979	1980
Total loans and investments	65.0	72.7	56.5	75.8	56.6	74.1
Total loans	50.2	68.7	53.1	71.5	53.4	70.8
Total C & I loans	28.1	38.9	29.7	40.3	29.6	38.9
To U.S. addressees	18.2	25.2	18.8	26.1	18.7	24.9
To smaller businesses	0.5	0.7	0.5	0.7	0.5	0.7
Real estate loans, resid. prop.	0.1	0.1	0.1	0.1	0.1	0.1
Agricultural loans	*	*	*	*	*	*
All other loans	22.0	29.7	23.3	31.0	23.8	31.8
Lease financing receivables	*	*	*	*	*	*
U.S. customers' liability on acceptances	3.4	4.4	3.8	4.6	3.9	4.7
Loan commitments	32.5	59.4	33.3	64.5	35.1	65.0
Total loans and leases	28.0	42.0	27.9	43.5	28.5	40.9

	December 1979	March 14, 1980
Memo: Total loans and leases to U.S. addressees	39.8	xxxxxx
Loan commitments to U.S. addressees	51.1	62.8

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* Less than $50 million.

Table IIB2 (cont'd)

	Change from December 1979		
	February	March	April
Total loans and leases to U.S. addressees	2.1	3.7	1.1
Loan commitments to U.S. addressees	8.2	13.3	13.9

Table II83
Selected Financial Data
(Percent changes in amounts outstanding)

U.S. Branches and Agencies of Foreign Banks
All Asset Sizes

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Total loans and investments	11.9	34.1	30.8
Total loans	36.8	34.7	32.5
Total C & I loans	38.3	35.8	31.3
To U.S. addressees	38.7	38.8	32.9
To smaller businesses	37.2	41.2	27.6
Real estate loans, resid. prop.	--	--	--
Agricultural loans	--	--	--
All other loans	34.8	33.2	33.9
Lease financing receivables	--	--	--
U.S. customers' liability on acceptances	20.8	21.8	19.2
Loan commitments	82.5	93.8	85.1
Total loans and leases	30.0	36.0	43.4

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Total loans and investments	-13.1	4.2	0.1	-2.3
Total loans	3.7	4.1	0.7	-0.9
Total C & I loans	5.6	3.7	-0.3	-3.6
To U.S. addressees	3.6	3.7	-0.4	-4.7
To smaller businesses	--	--	--	--
Real estate loans, resid. prop.	--	--	--	--
Agricultural loans	--	--	--	--
All other loans	5.8	4.6	1.0	2.5
Lease financing receivables	--	--	--	--
U.S. customers' liability on acceptances	11.3	5.3	3.8	1.5
Loan commitments	2.3	8.6	5.6	0.9
Total loans and leases	-0.3	3.7	2.3	-9.9

Table IIB3 (cont'd)

	Change from December 1979		
	February	March	April
Total loans and leases to U.S. addressees	5.3	9.2	2.7
Loan commitments to U.S. addressees	16.1	26.1	27.2

Table IIB4
Loans, by Type
(Percentage distribution)

U.S. Branches and Agencies of Foreign Banks
All Asset Sizes

All Federal Reserve Districts

Type of loan	February 1979	February 1980	March 1979	March 1980	April 1979	April 1980
Total loans	100.0	100.0	100.0	100.0	100.0	100.0
Total C & I loans	56.0	56.6	55.9	56.4	55.4	54.9
To U.S. addressees	36.2	36.7	35.5	36.5	35.0	35.2
To smaller businesses	1.0	1.0	1.0	1.0	1.0	1.0
Real estate loans, resid. prop.	0.1	0.1	0.1	0.1	0.1	0.2
Agricultural loans	0.0	0.0	0.0	0.0	0.0	0.0
All other loans	43.8	43.2	43.9	43.4	44.5	44.9
Total C & I loans	100.0	100.0	100.0	100.0	100.0	100.0
To U.S. addressees	64.6	64.8	63.4	64.8	63.3	64.0
To smaller businesses	1.9	1.8	1.7	1.8	1.8	1.8

Table IIB5
Relationship of Unused Loan Commitments to Total Loans and Leases

U.S. Branches and Agencies of Foreign Banks
All Asset Sizes

All Federal Reserve Districts

	1979	1980		
	December	February	March	April
	(percent)			
Unused commitments/ Total loans and leases	128.3	141.4	148.1	138.8

Table IIC1
Selected Financial Data
(Distributions of individual respondent percent changes in amounts outstanding)

U.S. Branches and Agencies of Foreign Banks
All Asset Sizes

All Federal Reserve Districts

	Change from year-ago month (quartiles)								
	February			March			April		
	1	2	3	1	2	3	1	2	3
Total loans and investments	4.5	40.0	76.4	6.4	38.5	70.7	8.6	34.2	70.0
Total loans	9.4	41.5	81.6	7.9	41.0	71.6	8.0	35.8	71.8
Total C & I loans	4.1	36.6	98.3	3.7	29.0	86.6	2.4	33.0	83.6
To U.S. addressees	3.9	42.1	132.8	-0.2	30.7	116.7	-3.1	28.0	93.8
To smaller businesses	-9.4	31.0	80.8	-7.4	14.7	103.1	-17.6	4.6	56.4
Real estate loans, resid. prop.	6.6	38.6	90.8	-7.1	21.0	61.2	-7.9	28.1	60.6
Agricultural loans	*	*	*	*	*	*	*	*	*
All other loans	2.8	51.2	151.9	0.0	49.8	171.1	-4.5	37.4	123.4
Lease financing receivables	*	*	*	*	*	*	*	*	*
U.S. customers' liability on acceptances	-52.2	15.9	138.7	-62.9	-1.2	85.8	-62.6	7.8	186.8
Loan commitments	22.3	65.7	136.7	20.3	72.6	195.3	13.5	62.8	154.9
Total loans and leases	1.6	41.4	93.7	4.7	45.3	116.6	3.5	35.8	123.3

	Change from preceding month (quartiles)											
	March 1979			March 1980			April 1979			April 1980		
	1	2	3	1	2	3	1	2	3	1	2	3
Total loans and investments	-2.3	5.1	17.8	-1.8	3.9	13.2	-6.0	0.8	10.0	-8.8	0.0	6.6
Total loans	-2.1	5.3	17.9	-1.8	4.7	12.4	-5.2	1.1	9.6	-9.2	-0.4	7.2
Total C & I loans	-2.1	3.9	16.3	-4.5	1.9	11.9	-6.6	1.8	9.0	-10.5	-0.1	7.6
To U.S. addressees	-2.8	3.5	14.1	-9.7	0.0	12.1	-9.5	2.1	8.9	-10.6	-1.1	10.0
To smaller businesses	-10.7	0.0	7.3	-6.1	-0.3	8.9	-7.8	3.3	22.2	-17.9	-0.9	5.5
Real estate loans, resid. prop.	-0.5	0.9	5.6	-0.6	0.0	3.8	-2.1	0.0	1.8	-2.0	0.0	2.9
Agricultural loans	*	*	*	*	*	*	*	*	*	*	*	*
All other loans	-7.7	3.4	25.3	-2.9	8.2	28.6	-12.6	2.8	29.3	-18.8	-1.4	15.7
Lease financing receivables	*	*	*	*	*	*	*	*	*	*	*	*
U.S. customers' liability on acceptances	-8.5	5.1	20.8	-28.7	-4.8	11.7	-41.6	-0.9	20.7	-28.7	-2.0	44.7
Loan commitments	-1.3	0.0	7.8	-0.5	2.6	13.7	-3.2	0.4	12.7	-9.1	-0.3	3.8
Total loans and leases	-6.4	1.3	14.0	-2.6	3.6	17.6	-6.6	2.7	14.4	-17.4	-1.2	7.9

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* The number of institutions reporting amounts in these categories is too small to compute quartiles.

Table IIC1 (cont'd)

	Change from December 1979 (quartiles)								
	February			March			April		
	1	2	3	1	2	3	1	2	3
Loan commitments to U.S. addressees	0.0	8.8	38.9	0.0	13.5	51.2	-2.5	13.2	48.1
Total loans and leases to U.S. addressees	-9.0	2.2	16.2	-6.4	8.1	26.5	-20.9	-1.9	24.1

	Change from December 1979*	February	March	April
	(percent)	(number of respondents)		
Total loans and leases to U.S. addressees	Actual:			
	less than 0.0	48	34	62
	0.0-5.99	19	18	6
	6.0-9.00	8	8	5
	over 9.00	56	71	58
	Annualized:			
	less than 0.0	48	34	62
	0.0-5.99	6	7	3
	6.0-9.00	2	0	1
	over 9.00	75	90	65

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* Excludes eight respondents with no loans and leases to U.S. addressees in December, 1979.

Table IIC2
Relationship of Unused Loan Commitments to Total Loans and Leases
(Distribution of individual respondent ratios)

U.S. Branches and Agencies of Foreign Banks
All Asset Sizes

All Federal Reserve Districts

	1979			1980								
	December			February			March			April		
	(quartiles)											
	1	2	3	1	2	3	1	2	3	1	2	3
Unused commitments (percent of total loans and leases)	1.4	49.4	124.0	0.3	53.1	154.2	3.0	58.4	152.0	1.1	56.7	171.5

Table IIIA1
Credit Demands and Loan Policies

Bank Holding Companies
Assets $1 Billion or More

All Federal Reserve Districts

	March	April
	(number of respondents)	
	161	161
Current strength of total private credit demands from U.S. addressees, as compared with the situation generally prevailing during February 1980 and taking account of seasonal patterns.		
Significantly greater	7	1
Essentially unchanged	138	123
Significantly less	16	37
Applications for commercial and industrial loans or loan commitments to meet basic credit demands for normal operations, as compared with the same month in recent years.		
Significantly larger	9	3
Essentially unchanged	127	109
Significantly less	25	49
Proportion of such applications approved.		
Significantly larger than usual	1	1
Essentially unchanged	133	135
Significantly smaller than usual	27	25
Applications for commercial and industrial loans to meet basic and emerging needs for smaller businesses, as compared with the same month in recent years.		
Significantly larger	3	3
Essentially unchanged	131	112
Significantly less	27	46
Proportion of such applications approved.		
Significantly larger than usual	0	0
Essentially unchanged	145	139
Significantly smaller than usual	16	22

Table IIIA1 (cont'd)

			March	April
Commercial and industrial loans for purely financial activities.				
Requests:	Yes		38	29
	No		123	132
Approvals:	Yes		10	10
	No		151	151
Commitment takedowns:		Yes	8	5
		No	153	156
Loans to business customers for speculative purposes.				
Requests:	Yes		36	26
	No		125	135
Approvals:	Yes		8	4
	No		153	157
Commitment takedowns:		Yes	6	3
		No	155	158

Table IIIB1
Selected Financial Data
(Amounts outstanding, in billions of dollars)

Bank Holding Companies
Assets $1 Billion or More

All Federal Reserve Districts

	February		March		April	
	1979	1980	1979	1980	1979	1980
Nonreporting subsidiaries						
U.S. nonbank						
C & I loans, U.S. addressees	7.4	9.3	7.8	9.6	7.7	9.6
U.S. commercial bank						
C & I loans, U.S. addressees	18.7	20.6	19.1	20.6	19.6	20.6
Non-U.S. bank and nonbank						
C & I loans, U.S. addressees	0.2	0.2	0.2	0.2	0.2	0.2
U.S. & non-U.S. commercial bank						
U.S. cust. liab. on accept.	*	0.1	0.1	0.1	*	0.1
Loan commitments	12.0	14.2	13.2	15.3	13.0	15.4
All nonreporting subsidiaries						
Total loans and leases	85.0	97.3	86.0	98.2	83.9	93.8

	December 1979	March 14, 1980
Memo: Total loans and leases to U.S. addressees	94.8	xxxxxx
Loan commitments to U.S. addressees by nonreporting bank subsidiaries	16.4	14.7

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* Less than $50 million.

Table IIIB2
Selected Financial Data
(Changes in amounts outstanding, in billions of dollars)

Bank Holding Companies
Assets $1 Billion or More

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Nonreporting subsidiaries			
U.S. nonbank			
C & I loans, U.S. addressees	1.9	2.0	1.9
U.S. commercial bank			
C & I loans, U.S. addressees	1.9	1.5	1.0
Non-U.S. bank and nonbank			
C & I loans, U.S. addressees	*	*	*
U.S. & non-U.S. commercial bank			
U.S. cust. liab. on accept.	*	*	*
Loan commitments	2.2	2.1	2.4
All nonreporting subsidiaries			
Total loans and leases	12.3	12.2	9.9

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Nonreporting subsidiaries				
U.S. nonbank				
C & I loans, U.S. addressees	0.2	0.3	0.1	*
U.S. commercial bank				
C & I loans, U.S. addressees	0.4	0.0	0.5	*
Non-U.S. bank and nonbank				
C & I loans, U.S. addressees	*	*	*	*
U.S. & non-U.S. commercial bank				
U.S. cust. liab. on accept.	*	*	*	*
Loan commitments	1.2	1.1	-0.2	0.1
All nonreporting subsidiaries				
Total loans and leases	1.0	0.9	-2.1	-4.4

	Change from December 1979		
	February	March	April
Total loans and leases to U.S. addressees	2.5	3.4	-1.0
Loan commitments to U.S. addressees by nonreporting subsidiaries	-0.2	0.9	1.0

---

* Less than $50 million.

Table III83
Selected Financial Data
(Percent changes in amounts outstanding)

Bank Holding Companies
Assets $1 Billion or More

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Nonreporting subsidiaries			
U.S. nonbank			
C & I loans, U.S. addressees	25.7	26.3	24.7
U.S. commercial bank			
C & I loans, U.S. addressees	10.2	7.9	5.1
Non-U.S. bank and nonbank			
C & I loans, U.S. addressees	--	--	--
U.S. & non-U.S. commercial bank			
U.S. cust. liab. on accept.	--	--	--
Loan commitments	18.3	15.9	18.5
All nonreporting subsidiaries			
Total loans and leases	14.4	14.2	11.8

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Nonreporting subsidiaries				
U.S. nonbank				
C & I loans, U.S. addressees	2.7	3.2	1.3	--
U.S. commercial bank				
C & I loans, U.S. addressees	2.1	--	2.6	--
Non-U.S. bank and nonbank				
C & I loans, U.S. addressees	--	--	--	--
U.S. & non-U.S. commercial bank				
U.S. cust. liab. on accept.	--	--	--	--
Loan commitments	10.0	7.7	1.5	0.7
All nonreporting subsidiaries				
Total loans and leases	1.2	0.9	-2.4	-4.5

	Change from December 1979		
	February	March	April
Total loans and leases to U.S. addressees	2.6	3.6	-1.1
Loan commitments to U.S. addressees by nonreporting subsidiaries	-1.4	6.2	6.9

Table IIIB4
Relationship of Unused Loan Commitments to Total Loans and Leases

Bank Holding Companies
U.S. Assets $1 Billion or More

All Federal Reserve Districts

	1979	1980		
	December	February	March	April
		(percent)		
Unused commitments/ Total loans and leases	15.2	14.6	15.6	16.4

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Table IIIC1
Total Loans and Leases to U.S. Addressees
(Distributions of individual respondent percent changes)

Bank Holding Companies
U.S. Assets $1 Billion or More

All Federal Reserve Districts

Change from year-ago month (quartiles)								
February			March			April		
1	2	3	1	2	3	1	2	3
2.7	9.0	15.7	2.4	8.6	14.6	0.8	5.9	12.6

Change from preceding month (quartiles)											
March 1979			March 1980			April 1979			April 1980		
1	2	3	1	2	3	1	2	3	1	2	3
0.0	1.0	1.8	-0.5	0.0	1.1	-1.2	1.1	2.7	-2.0	-0.3	0.9

Change from December 1979 (quartiles)								
February			March			April		
1	2	3	1	2	3	1	2	3
-2.3	-0.3	1.2	-1.9	-0.1	1.8	-5.4	-0.5	2.3

Change from December 1979* (percent)	February	March	April
	(number of respondents)		
Actual:			
less than 0.0	83	79	85
0.0-5.99	54	54	43
6.0-9.00	5	7	10
over 9.00	10	12	14
Annualized:			
less than 0.0	83	79	85
0.0-5.99	27	29	28
6.0-9.00	4	9	4
over 9.00	38	35	35

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* Excludes nine respondents with no loans and leases to U.S. addressees in December, 1979.

Table IVA1
Credit Demands and Loan Policies

Finance Companies
Business Receivables $1 Billion or More

All Federal Reserve Districts

	March	April
	(number of respondents)	
	15	15
Current strength of total private credit demands from U.S. addressees, as compared with the situation generally prevailing during February 1980 and taking account of seasonal patterns.		
Significantly greater	4	1
Essentially unchanged	9	8
Significantly less	2	6
Applications for business loans to meet basic credit demands for normal operations, as compared with the same month in recent years.		
Significantly larger	6	3
Essentially unchanged	6	7
Significantly less	3	5
Proportion of such applications approved.		
Significantly larger than usual	2	1
Essentially unchanged	9	12
Significantly smaller than usual	4	2
Applications for business loans to meet basic and emerging needs for smaller businesses, as compared with the same month in recent years.		
Significantly larger	3	0
Essentially unchanged	9	10
Significantly less	3	5
Proportion of such applications approved.		
Significantly larger than usual	1	0
Essentially unchanged	10	13
Significantly smaller than usual	4	2

Table IVA1 (cont'd)

	March	April
Business loans for purely financial activities.		
Requests: Yes	3	1
No	12	14
Approvals: Yes	0	1
No	15	14
Commitment takedowns: Yes	0	0
No	15	15
Loans to business customers for speculative purposes.		
Requests: Yes	0	0
No	15	15
Approvals: Yes	0	0
No	15	15
Commitment takedowns: Yes	0	0
No	15	15

Table IVB1
Selected Financial Data
(Amounts outstanding, in billions of dollars)

Finance Companies
Business Receivables $1 Billion or More

All Federal Reserve Districts

	February		March		April	
	1979	1980	1979	1980	1979	1980
Total accounts receivable	68.3	76.5	73.0	81.0	74.5	81.6
Total business receivables	40.6	43.1	40.1	45.5	44.4	45.7
From U.S. addressees	38.6	40.4	39.5	40.5	43.8	44.9
From smaller businesses	26.9	28.0	27.7	28.0	30.0	29.6
Lease financing receivables	9.1	9.5	10.3	9.5	10.3	10.8
Business loans by foreign offices to U.S. addressees	0.0	0.0	0.0	0.0	0.0	0.0

Table IVB2
Selected Financial Data
(Changes in amounts outstanding, in billions of dollars)

Finance Companies
Business Receivables $1 Billion or More

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Total accounts receivables	8.2	8.0	7.1
Total business receivables	2.5	5.4	1.3
From U.S. addressees	1.8	1.0	1.1
From smaller businesses	1.1	0.3	-0.4
Lease financing receivables	0.4	-0.8	0.5
Business loans by foreign offices to U.S. addressees	--	--	--

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Total accounts receivables	4.7	4.5	1.5	0.6
Total business receivables	-0.5	2.4	4.3	0.2
From U.S. addressees	0.9	0.1	4.3	4.4
From smaller businesses	0.8	*	2.3	1.6
Lease financing receivables	1.2	*	*	1.3
Business loans by foreign offices to U.S. addressees	--	--	--	--

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* Less than $50 million.

Table IVB3
Selected Financial Data
(Percent changes in amounts outstanding)

Finance Companies
Business Receivables $1 Billion or More

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Total accounts receivables	12.0	11.0	9.5
Total business receivables	6.2	13.5	2.9
From U.S. addressees	4.7	2.5	2.5
From smaller businesses	4.1	1.1	-1.3
Lease financing receivables	4.4	-7.8	4.9
Business loans by foreign offices to U.S. addressees	--	--	--

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Total accounts receivables	6.9	0.1	2.1	0.7
Total business receivables	*	5.6	10.7	0.4
From U.S. addressees	2.3	0.2	10.9	10.9
From smaller businesses	3.0	*	8.3	5.7
Lease financing receivables	13.2	*	*	13.7
Business loans by foreign offices to U.S. addressees	--	--	--	--

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* Less than .05 percent.

Table VA1
Selected Financial Data
(Amounts outstanding, in billions of dollars)

Selected Corporations

All Federal Reserve Districts

	February		March		April	
	1979	1980	1979	1980	1979	1980
			365 Respondents			
Commercial paper issued in U.S.	xx	xx	xx	xx	xx	xx
Amount outstanding	58.7	75.1	58.8	75.2	62.3	79.1
Total backup U.S. bank lines	73.4	100.0	74.9	125.3	76.1	107.0
Indebtedness to non-U.S. entities	13.4	19.3	14.4	20.4	12.5	19.6
Foreign offices of U.S. banks	2.0	2.0	2.1	2.0	1.8	2.0
Foreign offices non-U.S. banks	2.6	3.9	2.7	4.7	2.7	5.0
Non-U.S. affiliates (net)	3.1	6.0	3.4	6.4	1.9	5.5
Other non-U.S. sources	5.7	7.1	6.2	7.4	6.1	7.2

Table VA2
Selected Financial Data
(Changes in amounts outstanding, in billions of dollars)

Selected Corporations

All Federal Reserve Districts

	Change from year-ago month		
	February	March	April
Commercial paper issued in U.S.	xx	xx	xx
Amount outstanding	16.4	16.4	16.8
Total backup U.S. bank lines	26.6	50.4	30.9
Indebtedness to non-U.S. entities	5.9	6.0	7.1
Foreign offices of U.S. banks	*	-0.1	0.2
Foreign offices non-U.S. banks	1.3	2.0	2.3
Non-U.S. affiliates (net)	2.9	3.0	3.6
Other non-U.S. sources	1.4	1.2	1.1

	Change from preceding month			
	March		April	
	1979	1980	1979	1980
Commercial paper issued in U.S.				
Amount outstanding	0.1	0.1	3.5	3.9
Total backup U.S. bank lines	1.5	25.3	1.2	-18.3
Indebtedness to non-U.S. entities	1.0	1.1	-1.9	-0.8
Foreign offices of U.S. banks	0.1	*	-0.3	*
Foreign offices non-U.S. banks	0.1	0.8	*	0.3
Non-U.S. affiliates (net)	0.3	0.4	-1.5	-0.9
Other non-U.S. sources	0.5	0.3	-0.1	-0.2

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* Less than $50 million.

THE CONSUMER CREDIT RESTRAINT PROGRAM

One element of the credit restraint package was designed to limit the growth of certain types of consumer credit--all open-end credit, such as credit-card debt, and closed-end credit either unsecured or secured by collateral not being purchased with the proceeds of the credit. As with other elements of the program, consumer credit controls were regarded as supplementary to the pursuit of restraint through traditional tools of monetary policy, and were intended to discourage the flow of available funds into unproductive or speculative uses. Selected types of closed-end consumer credit, such as auto loans, were exempted from this part of the program in view of the evident weakness in demands for various types of consumer durable goods. Borrowing for the purchase or improvement of a home also was excluded.

To discourage overly expansive growth in covered consumer credit, the Board's program required that creditors maintain a non-interest-bearing deposit with the Federal Reserve equal to 15 percent of any increase above a base amount in covered consumer credit outstanding. Originally, the base amount was to have been the amount of covered credit outstanding on March 14, 1980, but the Board subsequently provided for an optional base calculation that would permit, without penalty, seasonal fluctuation and some initial underlying growth. Creditors with less than $2 million of covered credit were exempted.

The special deposit requirement tied to credit growth created a cost disincentive against expansion of covered types of credit, but allowed lending institutions considerable flexibility regarding the specific means used to slow credit growth. It contrasted with credit controls programs during the Korean and Second World War periods, in which the Board had established maximum loan maturity and minimum downpayment requirements for a wide variety of loans.

In both 1977 and 1978, prior to the credit controls program, consumer credit outstanding had expanded by almost 20 percent, with particular strength in auto credit and in revolving credit. As sales of domestically produced automobiles weakened in the spring of 1979, however, growth in automobile (and total) consumer credit began to slow, while revolving credit remained generally strong. By the second half of last year, expansion in total consumer installment credit had fallen to an 11 percent annual rate, and it eased further, to a 7 percent pace, in the first quarter of 1980. By the end of last year, revolving credit also was growing at a reduced rate, but accelerating inflation in early 1980 raised the possibility that card-holders might decide to draw more heavily upon their open lines of credit. The application of controls to revolving credit and other selected types of personal loans was intended to reinforce the emerging trend toward less intensive use of credit.

In the first few weeks after controls were announced, many commercial banks, other lending institutions, and some retailers took initial or further steps to restrict the supply of consumer credit, most often by adopting more stringent credit approval standards. Many banks instituted user fees on credit cards, lowered maximum borrowing limits, or stopped issuing credit cards altogether. Several banks had taken such measures before March 14 in response to sharply higher costs of funds and statutory ceilings on lending rates, but the announcement of controls triggered a marked stepup in such actions. Retailers most commonly tightened credit terms through stricter lending standards and by raising minimum monthly payment requirements.

Meanwhile, consumers voluntarily cut back substantially on borrowing after the credit restraints were invoked. Retail stores in particular reported a steep decline in credit card usage and a sudden drop in applications for new accounts. Banks also noted sharply reduced credit card use and loan demand. Some consumers may have been confused about how controls would affect them, or may have expected repayment terms to be tightened severely, which motivated them to avoid new credit purchases. Some may have reacted cautiously to uncertainty over the economic impact that controls would exert, particularly in light of the historically high levels of consumer indebtedness and the low rate of saving that had been reached in recent months.

Consumer installment credit contracted at a seasonally adjusted annual rate of 8 percent in April, the first full month under credit controls, and 13 percent in May, compared with increases of 3 percent in March and 7 percent during the first quarter as a whole. By May, the volume of new credit extended was 25 percent below the peak level in September 1979. The April-May decline in outstanding debt was the largest--in percentage as well as in dollar terms--since the World War II period. Still unclear is the extent to which the restraints on consumer credit, as well as the Board's guidelines for overall loan expansion at commercial banks and finance companies, contributed to the decline in credit outstanding in April-May. However, the suddenness of the shift from positive to negative growth, and qualitative information from Federal Reserve System surveys and other sources, indicates that the program did exert downward pressure on both credit supply and demand.

Although consumer credit outstanding declined on balance in April and May, about one-sixth of the institutions subject to the program experienced increases in covered credit and thus were liable for maintaining a special deposit with the Federal Reserve. In April a total of 1,027 institutions placed an aggregate of $81.4 million in special depostis. The total special deposit remained at $81 million in May. The largest aggregate deposits in April were reported by groups designated as savings and loan associations, followed by commercial banks and bank holding companies (see table). (Multiunit firms were classified into whichever category represented 60 percent or more of their business; thus reporting categories do not correspond precisely to customary industry groupings.)

On May 22, in view of the broadly curtailed use of credit since mid-March, the Board modified its credit restraint program. Under the consumer credit controls, the deposit requirement on increases in covered credit was lowered to 7-1/2 percent from 15 percent for credit outstanding in June. On July 3, the Board announced plans to complete the phase-out of the special measures of credit restraint, as evidence accumulated that the need for such extraordinary measures had ended. Thus no further special deposits were to be required after the end of the then-prevailing deposit maintenance period on July 23, 1980.

COVERED CONSUMER CREDIT AND SPECIAL DEPOSITS BY TYPE OF CREDITOR,[1]
APRIL 1980
(Amounts in millions of dollars)

Type of institution	Institutions with covered credit above base				All institutions with covered credit	
	Amount				Amount of credit base	Number
	Credit base	Credit above base	Special deposit	Number		
Commercial banks and bank holding companies	9,130	107.8	16.1	287	205,515	2,815
Mutual savings banks	1,078	53.5	8.0	109	2,589	243
Credit unions	1,603	22.0	3.3	163	16,629	1,824
Savings and loan associations	13,005	247.8	37.2	409	33,626	1,050
Finance companies	2,221	28.5	4.3	10	13,871	152
Retail stores	321	3.0	0.5	22	9,496	244
Oil companies	1,928	61.3	9.2	17	2,532	28
Conglomerates and others	709	18.9	2.9	10	15,165	46
All Groups	29,995	542.8	81.4	1,027	299,424	6,402

Note: Multi-unit firms operating within two or more separate categories are classified in whichever category accounts for at least 60 percent of the firm's business. If no unit accounts for 60 percent of a firm's business, the firm is classified as a conglomerate.

[1] Disaggregated data for May not yet available.

THE MANAGED LIABILITY MARGINAL RESERVE AND SPECIAL DEPOSIT PROGRAMS

The Board's reserve action of October 6 established an 8 percent marginal reserve requirement for large member banks, Edge Corporations, and the U.S. branches and agencies of foreign banks against net increases in covered managed liabilities above a base period level.[1] This program was designed to damp the rate of expansion of bank credit available to domestic residents by increasing the cost of managed liablities used to finance such expansion. It was announced as part of a policy package intended to better control bank credit and the monetary aggregates.[2]

As shown in Table 1, the amount of managed liabilities in excess of base levels at all institutions, and thus subject to marginal reserve requirements, declined during the fourth quarter. This was largely attributable to a reduction in reservable managed liabilities at agencies and branches.

Table 2 shows detail for a sample consisting of 25 large domestic chartered banks that held over $120 billion of managed liabilities during the base period, which accounted for roughly 60 percent of total covered member bank managed liabilities at that time.[1] Managed liabilities at these 25 banks declined between the base period and the week ending December 26 by about $5-1/4 billion. As of this week, 22 of these banks were not required to hold marginal reserves, since their managed liabilities were below their base levels. For these 22 banks, this "cushion" below base levels totaled about $5-1/2 billion.

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[1] The original base period was the two statement weeks ending September 26, 1979. For institutions whose managed liabilities were less than $100 million during the base period, the base level was calculated as follows: if managed liabilities were positive, the base was set equal to $100 million; if managed liabilities were negative--that is, the institution was a net creditor of its foreign offices--the base was set equal to the algebraic sum of $100 million and the base period level of managed liabilities. Covered managed liabilities included large time deposits with original maturity of less than one year, certain Eurodollar borrowings, repurchase agreements net of trading accounts, and federal funds borrowings from institutions not subject to the marginal requirement.

[2] Other actions taken were an increase in the discount rate from 11 to 12 percent and a change in the method used to conduct monetary policy. The latter involved a shift in emphasis in day-to-day operations away from confining federal funds rate fluctuations toward controlling the supply of bank reserves.

Table 3 shows detail for branches and agencies of foreign banks. Of the 132 foreign bank "families" represented, only 11 were over their bases as of the week ending December 26 by a total amount of about $1/2 billion.[2] As a group, branches and agencies were below their aggregate base by about $9-1/4 billion at this time. This net cushion was about one-fourth of these institutions' total managed liabilities.

The decline of covered managed liabilities during the fourth quarter appears largely to have been the by-product of slow bank credit growth. The resulting large net cushion below base levels by the end of the fourth quarter indicated an absence of pressure resulting from the marginal reserve program on bank costs of funds, since the cushion at banks below their bases could easily be transmitted to those banks above. Banks below their bases could acquire funds through issuing managed liabilities without being subject to marginal reserve requirements.

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[1] There were 251 member banks with managed liabilities of more than $100 million and thus required to file base reports. These banks had total managed liabilities of about $220 billion. No individual bank data on managed liabilities are available throughout the full period for the banks other than those in the 25 bank sample.

[2] All U.S. branches and agencies of a foreign bank reported on a consolidated basis. The 132 foreign bank families were those that reported each week throughout the period.

Further, since federal funds borrowed from member banks and branches and agencies of foreign banks were exempt from the program, funds raised by banks below their bases could be passed to banks at or above their base levels. Thus, banks were in a position to fund additional credit growth without incurring significant marginal reserve requirements.

During January and February, as bank credit growth began to accelerate, bank reliance on managed liabilities increased. As shown in Table 1, both the number of institutions above their base levels and the amounts in excess increased somewhat during this period. Table 2 shows that, at the 25 large member banks, the number of banks in excess increased from 3 to 5 from the week ending December 26 to the week ending February 27. The net cushion below the 25 banks' aggregate base fell substantially, from $5-1/4 billion to $2 billion. As shown in Table 3, the number of agencies and branches in excess of their base levels also increased during this period--from 11 to 19--while the foreign bank families' net cushion below their aggregate base fell from $9-1/4 billion to about $7 billion.

The discrepancy between strong credit growth and somewhat slower growth in reservable managed liabilities reflected a reduction in the net cushion and efforts to economize on covered managed liabilities as a source of funding. One method for economizing involved purchases of federal funds from small member banks well below their bases of $100 million. Small banks financed such sales in part with funds obtained from money market certificates which grew strongly during the first quarter. In addition, banks apparently stepped up sales of large CDs with original maturity of one year or more.

On March 14, as part of the overall credit restraint program, the Board announced a tightening of the marginal reserve program. This involved an increase from 8 to 10 percent in the marginal reserve requirement and a reduction in the base used to calculate the reserve requirement. The base, effective the week ending March 26, was reduced by either 7 percent or by the net reduction in foreign loans that had occurred between the September base period and the week ending March 12, whichever was greater.[1] Additional reductions in foreign loans after March 12 would further reduce the base. The reduction in the base resulted in a substantial increase in managed liabilities above the new base during the week ending March 26.

In addition to the tightening of the marginal reserve program, the March action extended similar requirements to nonmember banks with managed liabilities of over $100 million. These banks were required to maintain non-interest-bearing special deposits equal to 10 percent of any increases in their managed liabilities over their base levels as of the two-week period ending March 12. Sixty-one nonmember banks had managed liabilities of at least $100 million during the base period.[2] These banks had total managed liabilities during the base period of about $17 billion.

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[1] The latter provision affected primarily 30 foreign bank families whose bases were reduced by an average of about one-fourth. Prior to the March action, banks were able to finance domestic credit growth without incurring marginal reserve requirements by reducing foreign loans.

[2] Subsequently, a few additional nonmember banks' managed liabilities went above $100 million and thus became subject to the program.

As shown on Table 1, the number of member banks and foreign bank families in excess of their base levels, as well as the amounts in excess, were substantially increased as a result of the March actions. In addition, 43 nonmember banks were in excess of their bases during the week ending March 26. However, the aggregate amount in excess of base levels at these banks was only about $1/2 billion. Table 2 displays the reversal of the position of the 25 member banks relative to their bases, from a net cushion of $2 billion for the week ending February 27 to a net excess of about $10 billion for the week ending March 26. Foreign bank family data, shown in Table 3, reveal the virtual elimination of the net cushion below base levels at these institutions. The sharp reduction of the net cushion at foreign bank families and the development of a substantial net excess at the 25 member banks had the result of increasing the cost of managed liability funding to covered institutions.[1]

During April and May, the weakening of bank credit was accompanied by a sharp reduction of the amounts in excess of base levels at member banks and foreign bank families (Table 1). At nonmember banks, both the number of institutions over their base levels and the aggregate amount in excess fell by about one-half.

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[1] This increased cost of managed liabilities was reflected in the substantial spread that developed during this period between rates on nonreservable federal funds purchased from member banks and reservable federal funds purchased from nonmembers.

As part of the overall easing of the credit restraint package announced on May 22, base levels at all covered institutions were increased by 7-1/2 percent[1] while the marginal reserve and special deposit requirements were reduced from 10 to 5 percent, effective the week ending June 4. As shown in Table 1, by June 25 the number of member banks and foreign bank families over their bases and the amounts in excess had fallen to about the same levels that existed just prior to the March action. At nonmember banks, the number of banks and the amounts in excess of base levels declined further. Tables 2 and 3 show that substantial cushions had developed by June 25 at both the 25 member banks and the foreign bank families.

On July 3, the Board announced the removal of the marginal reserve requirement on managed liabilities at member banks and foreign bank families, as well as the special deposit requirement on managed liabilities at nonmember banks, effective the week beginning July 10.

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[1] Banks whose original bases were $100 million or less were not affected by this action.

Table 1

Covered Managed Liabilities

Week Ending	Number of Institutions above Base Levels			Amount in Excess of Base ($ billions)			
	Members[1/]	Branches and Agencies	Non-members	Members[1/]	Branches and Agencies	Non-members	Total
1979--Oct. 31	102	28		2.9	1.5		4.4
Nov. 28	126	10		4.7	.3		5.0
Dec. 26	92	11		2.3	.4		2.7
1980--Jan. 30	111	11		2.9	.4		3.2
Feb. 27	115	19		3.0	1.1		4.0
Mar. 26	199	44	43	16.8	3.8	.6	21.2
Apr. 30	138	24	20	7.9	1.6	.4	9.9
May 28	155	24	17	10.2	2.0	.3	12.6
June 25	95	22	10	3.3	1.5	.3	5.1

1/ Includes Edge Act corporations.
Figures may not add due to rounding.

Table 1 (continued)

Week Ending[1]	Marginal Reserves[2] ($ millions)[3]		Special Deposits[2] ($ million) [3]
	Member Banks	Branches and Agencies	Nonmember Banks
1979--Oct. 31	230	120	
Nov. 28	380	20	
Dec. 26	180	30	
1980--Jan. 30	230	30	
Feb. 27	240	90	
Mar. 26	1,680	380	60
Apr. 30	790	160	40
May 28	1,030	200	30
June 25	170	70	20

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[1] These are the statement weeks during which the managed liabilities in excess of base levels were reported. The marginal reserves and special deposits were required to be held 2 weeks after the statement week.

[2] The required marginal reserves and special deposits are calculated by multiplying the amounts in excess of base levels by the appropriate marginal reserve or special deposit requirement ratios.

[3] Rounded to nearest $10 million.

Table 2

25 Member Banks*

($ billions)

Week Ending		Number of Institutions (1)	Current Managed Liabilities (2)	Base Level (3)	Excess (+) or Cushion (-) (2) - (3)
1979--Nov. 28	over base	9	62.7	60.1	+2.6
	under base	16	60.2	62.7	-2.5
	total	25	122.9	122.8	+0.1
Dec. 26	over base	3	25.1	24.7	+0.4
	under base	22	92.5	98.1	-5.6
	total	25	117.6	122.8	-5.2
1980--Jan. 30	over base	6	37.3	36.9	+0.4
	under base	19	81.9	85.9	-4.0
	total	25	119.2	122.8	-3.6
Feb. 27	over base	5	31.8	31.2	+0.6
	under base	20	89.0	91.6	-2.6
	total	25	120.8	122.8	-2.0
Mar. 26	over base	23	117.1	106.6	+10.5
	under base	2	6.4	6.8	-0.4
	total	25	123.5	113.4	+10.1
Apr. 30	over base	13	70.3	66.5	+3.8
	under base	12	45.1	46.3	-1.2
	total	25	115.4	112.9	+2.6
May 28	over base	14	67.4	61.1	+6.3
	under base	11	50.0	51.8	-1.8
	total	25	117.4	112.9	+4.5
June 25	over base	6	31.3	29.9	+1.5
	under base	19	84.3	91.6	-7.4
	total	25	115.6	121.5	-5.9

Figures may not add due to rounding.

*25 large member banks that reported throughout the period.

Table 3

Foreign Bank Families*

($ billions)

Week Ending		Number of Institutions (1)	Current Managed Liabilities (2)	Base Level (3)	Excess (+) or Cushion (-) (2) - (3)
1979--Nov. 28	over base	10	6.3	6.0	+0.3
	under base	122	32.6	42.5	-9.9
	total	132	38.9	48.5	-9.6
Dec. 26	over base	11	5.0	4.6	+0.4
	under base	121	34.2	43.9	-9.7
	total	132	39.2	48.5	-9.3
1980--Jan. 30	over base	11	7.4	7.0	+0.4
	under base	121	32.1	41.5	-9.4
	total	132	39.4	48.5	-9.1
Feb. 27	over base	19	14.8	13.7	+1.1
	under base	113	26.8	34.8	-8.0
	total	132	41.6	48.5	-6.9
Mar. 26	over base	43	24.8	21.0	+3.8
	under base	89	15.7	20.6	-4.9
	total	132	40.5	41.5	-1.0
Apr. 30	over base	24	13.2	11.6	+1.7
	under base	108	23.4	29.6	-6.3
	total	132	36.6	41.2	-4.6
May 28	over base	24	13.8	11.7	+2.1
	under base	108	21.9	29.3	-7.3
	total	132	35.7	40.9	-5.2
June 25	over base	22	12.0	10.5	+1.5
	under base	110	23.5	33.2	-9.7
	total	132	35.5	43.7	-8.2

Figures may not add due to rounding.

* 132 foreign bank families that reported throughout the period.

CREDIT RESTRAINT PROGRAM FOR MONEY MARKET FUNDS AND SIMILAR CREDITORS

As short-term interest rates rose to extraordinary levels in late 1979 and early 1980, the assets of money market mutual funds (MMMFs) and similar creditors climbed sharply. For example, MMMF assets increased almost $15 billion in the first two months of 1980. This unprecedented growth was diverting funds from thrift institutions and smaller commercial banks, and it threatened to interfere with reasonable flows of credit to several important segments of the economy, including housing, small businesses, and agriculture. The tendency for money market funds to channel funds from around the country to the central money market helped large borrowers meet their credit demands with relatively little restraint. One aspect of the set of monetary and credit actions adopted by the Board on March 14 was a provision requiring money market funds and similar creditors to maintain a special non-interest bearing deposit with the Federal Reserve equal to 15 percent of the amount by which the investment assets of these creditors exceeded their assets on March 14, 1980. The aim of the special deposit requirement was to restrain the growth of money market funds by reducing the returns on marginal increases in their shareholdings, and thereby to provide some greater assurance of the continued availability of funds to worthy borrowers who have access to only a limited range of credit sources while restraining flows of credit to other borrowers.

Total assets of MMMFs declined more than $1.0 billion over the four-week period following the mid-March announcement of the Credit Restraint Program (table 1). This decline probably was in response both to some uncertainty among investors about the impact of the special deposit requirement and, as anticipated, to decisions by many MMMF trustees to restrict or suspend sales of shares to new depositors.[1] To accommodate new depositors, a number of MMMF management companies organized and promoted new "clone" money market funds that are similar to their original counterparts except that all of their non-exempt assets are subject to the special non-interest bearing deposit requirement.

On March 28, the Board announced several modifications in the regulation applying to money market funds and similar entities to assure a more equitable treatment of similar types of shareholders. Among other actions, the Board extended the exemption for bank-operated collective investment funds to bona fide personal trusts, pension, retirement, and tax-exempt assets of money market funds that allocate at least 80 percent of their assets to short-term tax-exempt obligations, as well as providing a minimum base ($100 million) for money market funds engaged in continuous public offering on March 14. These Board actions, together with a wider availability of "clone" MMMFs, contributed to the beginning of a resurgence in growth in the assets of these creditors in the second half of April. Sales of MMMFs were buoyed further in May when several funds whose covered credit totals were below their base levels began accepting deposits of new shareholders.

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[1] On March 14, 1980, the SEC issued a general statement of policy (Investment Company Act of 1940; Release No. 11088) concerning some of the implications of the money market fund regulation in order to provide guidance to fund management companies and trustees. The statement expressed the view that money market fund boards of directors and investment advisers, consistent with their fiduciary obligations, should consider the appropriateness of continued sales of fund shares and the implementation of measures designed to protect the interests of existing shareholders against dilution. On April 22, 1980, the SEC promulgated additional rules (Investment Company Act of 1940; Release No. 11137) designed to facilitate the creation and issuance of more than one class of shares for MMMFs. Under these rules, a MMMF can create three classes of stock: one held primarily by existing shareholders, a second held by exempt accounts, and a third offered to new shareholders.

Non-interest bearing special deposits totaled $215 million over the week of April 14--the first week that such deposits were required at Federal Reserve Banks; approximately one-third of 101 reporting managed creditors maintained deposits (table 2).[1] By late May, special deposits totaled $433 million, and one-half of the 127 reporting creditors were maintaining deposits. On May 22, the Board announced modifications of its March 14 credit restraint program, including a reduction--effective for assets held in the week beginning June 16--from 15 to 7-1/2 percent in the special deposit requirement. Special non-interest bearing deposits peaked at $869 million in the week before the reduction; more recently, deposits totaled $547 million with approximately three-fourths of reporting creditors maintaining deposits. Since outstanding credit of reporting money market funds and similar creditors climbed $21.6 billion from early April to early July and covered credit increased only $9.4 billion, more than one-half of the increase in assets of these creditors have been in accounts that are exempt from the Board's special deposit requirement. In fact, almost one-half of the gain in MMMF assets since mid-March has been at funds that limit their depositors to institutional investors (these MMMFs accounted for less than one-fifth of total MMMF assets in early March), and a large portion of these accounts presumably are fiduciary in nature and exempt from the deposit requirement.

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[1] During the 7-day deposit maintenance period beginning April 14, 1980, each managed creditor was required to maintain a special deposit equal to the sum of the special deposits required for the reporting periods beginning March 14, March 24, and March 31.

The imposition of the special deposit requirement reduced the average net yield to MMMF shareholders. For example, the average 7-day net yield to shareholders of "clone" MMMFs was about 160 basis points less than "first generation" MMMFs over the seven day period ending July 3, 1980, and about two-thirds of this difference can be attributed to the 7-1/2 percent special non-interest bearing deposit requirement that was in effect over this period.[1/] (The remaining portion is attributable to the portfolio mix and average maturity of the "clone" assets.) Indeed, total assets of "clone" MMMFs have increased by less than $3.7 billion since the program was announced on March 14. However, total assets of non-clone MMMFs have climbed by more than $14.8 billion over this period. One reason for this large increase is that MMMF portfolio managers lengthened the average maturity of their portfolios in early April, thereby retarding the decline in their net yields to shareholders as the yield curve became upward sloping (table 3). Perhaps even more important, a sizable number of MMMFs calculate their net yields to shareholders by "marking to market" all or a portion of their assets on a daily basis. As a result, the sharp decline in money market interest rates resulted in annualized net yields to shareholders that were, because of the capital gains associated with the rise in prices of the money market obligations, well in excess of returns available on alternative investments. For example, the 7-day net yield to shareholders of first generation MMMFs exceeded the effective yields available on MMCs by 3-1/2 percentage points, on average, in the first four weeks of May, although this spread vanished

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[1/] Net yields exclude capital gains or losses.

in early July. In addition, MMMF portfolio managers also appear to have reallocated their investable funds away from lower yielding U.S. Treasury securities and toward other higher yielding money market obligations in order to maintain relatively attractive net yields to their portfolios.

Table 1
ASSETS AND NET YIELDS TO SHAREHOLDERS OF MONEY MARKET MUTUAL FUNDS

End of period		Total assets	Change from previous period		Average 7-day net yield to shareholders1/		Memo: MMC effective yield at thrifts
			First generation	Clones	First generation	Clones	
		------- Millions of dollars ------			----------------- Percent -----------------		
Feb.	6	55,232	2,179	--	12.78	--	12.37
	13	56,889	1,657	--	12.77	--	12.52
	20	58,148	1,259	--	12.78	--	12.81
	27	59,858	1,710	--	13.04	--	12.63
Mar.	5	60,620	762	--	13.22	--	14.30
	12	60,769	149	--	13.79	--	15.56
	19	61,288	519	--	14.13	--	15.74
	26	61,130	-158	--	14.59	--	15.73
Apr.	2	60,456	-699	25	15.04	--	16.55
	9	60,446	-75	65	15.56	15.80	15.57
	16	60,045	-472	71	16.03	17.00	14.95
	23	60,38[illegible]	204	139	16.32	15.46	14.21
	30	60,68[illegible]	98	203	16.03	13.90	12.42
May	7	63,028	2,075	254	15.52	11.89	11.24
	14	65,212	1,955	229	13.61	9.93	9.86
	21	67,642	2,152	278	12.72	10.06	9.33
	28	69,306	1,273	391	11.99	8.76	9.33
June	4	71,243	1,604	333	10.73	8.16	8.28
	11	72,851	1,608	216	10.63	8.16	8.98
	18	74,324	1,179	294	9.79	7.76	8.01
	25	75,595	1,054	217	9.19	7.53	8.01
July	2	76,848	940	313	8.66	7.50	8.01
	9	78,175	1,016	311	8.82	7.83	8.91
	16	79,170	685	310	8.57	7.71	8.93

1/ Net yield to shareholders after deduction of management fees and other expenses. Includes, in some cases, realized and unrealized capital gains or losses on existing portfolios.

Table 2
OUTSTANDING CREDIT, COVERED CREDIT AND NON-INTEREST BEARING SPECIAL DEPOSITS OF SHORT-TERM FINANCIAL INTERMEDIARIES
(Millions of dollars)

Period		Outstanding credit (1)	Covered credit (2)	(2)/(1)	Non-interest bearing special deposits
Apr.	6	n.a.	n.a.	--	--
	14	59,472	48,325	0.8126	215
	20	60,712	49,520	0.8157	123
	27	61,688	49,732	0.8062	125
May	4	62,542	50,014	0.7997	157
	11	63,123	50,080	0.7934	186
	18	68,696	50,444	0.7343	231
	25	70,511	52,185	0.7401	433
June	1	71,928	54,354	0.7557	355
	8	71,487	54,640	0.7643	681
	15	73,277	54,813	0.7480	778
	22	74,840	56,052	0.7490	869
	29	76,739	56,247	0.7677	486
July	6	79,666	57,039	0.7160	511
	13^p	81,034	57,735	0.7125	547

n.a.--not available. p--preliminary.

Table 3
PORTFOLIO COMPOSITION AND AVERAGE MATURITY
OF MONEY MARKET MUTUAL FUNDS
(Billions of dollars)

End of period	Total assets	Type of obligation								Average maturity (days)
		U.S. Gov't.								
		Treas.	Other	RPs	CDs	Euro CDs	CP	BA	Other	
1977	4.0	0.4	0.3	0.3	1.7	0.2	1.0	0.1	0.1	75
1978	11.0	0.4	1.0	0.4	4.8	0.5	2.9	0.8	0.1	48
1979-Q1	17.7	0.3	2.0	0.7	6.3	1.4	5.1	1.6	0.3	48
Q2	26.0	1.5	2.1	0.6	7.8	2.6	7.8	3.1	0.4	55
Q3	34.8	1.3	2.8	1.0	11.4	5.4	8.0	3.3	0.5	44
Q4	45.4	1.1	3.3	2.6	14.0	4.4	14.0	5.4	0.5	34
1980-Jan.	53.1	3.0	3.8	2.2	14.0	5.9	17.9	6.4	1.0	41
Feb.	60.3	4.1	3.6	2.8	16.0	6.3	18.7	7.9	0.9	38
Mar.	60.5	7.0	3.6	2.6	14.0	6.3	19.5	6.6	0.9	29
Apr.	60.7	5.3	4.0	2.4	13.9	5.4	20.6	8.6	0.6	38
May	70.0	6.6	4.2	3.4	15.3	6.4	24.3	8.3	1.5	38
June^p	76.7	4.4	6.8	3.6	16.2	6.8	28.2	9.1	1.6	49
Memo: Change										
12/31 to 3/31	+15.1	+5.9	+0.6	--	--	+1.9	+4.5	+1.2	+0.4	--
3/31 to 6/30^p	+16.2	-2.6	+3.2	+1.0	+2.2	+0.3	+8.7	+2.5	+0.7	--

p--preliminary.

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United States Senate
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, D.C. 20510

July 22, 1980

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The Honorable Paul A. Volcker
Chairman, Board of Governors of the
Federal Reserve System
Washington, D.C. 20551

Dear Mr. Chairman,

In addition to the questions that you answered at today's hearing on the conduct of monetary policy by the Federal Reserve System, I am enclosing several other questions that I would like you to answer for the hearing record.

I would greatly appreciate your answers in a timely manner so that the record can be printed as soon as possible.

Sincerely,

Bill Proxmire

William Proxmire
Chairman

WP:src

Your report correctly indicates that during the first half of this year growth in the narrow money stock measures M-1A and M-1B was below the ranges adopted by theFOMC last February. That being the case you have very considerable latitude during the last half of the year to hit your targets. For example, for M-1B the target range is 4.0 to 6.5 percent for the year, actual growth was 1.8 for the first half of 1980 so in the second half you can allow growth between 6.5 and 11.5 percent and still be consistent with your goal. That is a spread of 5 percentage points, which is so wide to be embarrassing. Your report says that "the FOMC believed it appropriate to foster a more gradual return of M-1 growth to the ranges established earlier."

Question: What does that mean for the second half of the year? Do you think that 11.5 percent M-1 growth over the next six months would be non-inflationary money growth? If not, why did the FOMC retain 6.5 percent annual growth as the top end of the M-1B target range for 1980?

The committee has supported the Federal Reserve's move to a reserve targeting procedure. I think that the flexibility in interest rates has been of significant importance during the last two months as interest rates have declined sharply. An important corollary to targeting reserves is management of the discount window in a manner in which reserve growth can be controlled. Last winter and early this spring the discount rate was consistently below market rates and banks had every incentive to borrow and they did. Then after March and April when interest rates peaked and started falling the discount rate became a penalty rate, and banks used the reserves being supplied by the Open Market Deal to pay-off their borrowing from the Fed. The committee has recommended that the discount rate be tied to market rates, and I understand that the Board has considered this.

Question: Can you tell us where you stand on this? How quickly will you move to a discount mechanism where the cost of borrowing is set at a penalty rate tied to market rates of interest?

Some critics of the Federal Reserve have said that in the last several weeks the Federal Reserve has purposely not permitted the Federal funds rate to fall as the market would have it because of concerns about the value of the dollar in international markets. If we are going to have fluctuating interest rates and fluctuating exchange rates as well, then the Federal Reserve should permit the market place to work. We cannot have the value of the dollar supported by domestic interest rate policies.

Question: I have some sympathy for that view. How do you respond to those critics? Has the Fed intervened to maintain interest rates in order to protect the value of the dollar?

There is a good chance that at the end of this recession the underlying rate of inflation, which is influenced greatly by unit labor costs, will be at 9 or 10 percent, compared to about 6 percent at the end of the recession in 1975. Thus, we will be starting a new expansion with an extremely high inflationary momentum.

Question: At that point what policies do we follow to reduce inflation at the same time as demand in the economy is picking up? And, if the answer is demand restraint, both fiscal and monetary, does that mean that the economic growth will be sluggish for an extended period of time?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

July 29, 1980

The Honorable William Proxmire
Chairman
Committee on Banking, Housing
  and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Chairman Proxmire:

Thank you for your letter of July 22. I am pleased to enclose responses to the additional questions submitted in connection with your Committee's hearing on July 22.

Please let me know if I can be of further assistance.

Sincerely,

Paul A Volcker

Enclosures

Response to question on M-1B growth in second half

I would not expect M-1B to grow at so rapid a rate in the second half of 1980 that growth for the whole year would be at the upper limit of its range. Unless it was clear that such a rapid rate of growth represented a shift in the public's demand to hold cash relative to income and interest rates, there would be too great a risk of exacerbating inflationary pressures. That is why the FOMC is seeking to foster a gradual return of M-1B to its longer-run growth ranges for 1980 and would also expect, at this time, that growth for the year would most likely be around or below the mid-point of its range.

Nonetheless, even though the chances that M-1B growth will be at the upper limit of its range for 1980 are rather small, it seemed to be excessive fine-tuning of the ranges to reduce the upper limit of the 1980 range for M-1B. First, it remains possible that banks--with nationwide NOW accounts on the near-term horizon and the legal basis of ATS accounts firm--will begin actively to promote ATS accounts in anticipation of expanded competition from thrifts in 1981; the associated shifts in deposits out of savings accounts would tend to raise M-1B growth. And second, mid-course corrections run the risk of creating unnecessary confusion in attempting to judge the course of Federal Reserve intentions with respect to the aggregates over a span of years. In that case it is better, unless there are compelling reasons otherwise, to maintain each year's targets on as comparable a basis as possible. It is more apt, for example, to compare the range for M-1B for 1981 with its present range for 1980 than with a range for 1980 that might have an upper limit reduced to reflect the exceptional development of the second quarter.

Response to question on discount rate

We have for some time studied the question of tying the discount rate to market rates, with the discount rate set at a penalty to the market, and the issue has been reviewed several times in Board discussions. While we do not consider the question closed, we have felt the potential advantages of the approach you outline are outweighed by important problems. In particular, in a period of rising market interest rates, when reserves supplied through open-market operations may be insufficient to meet required reserves, a tied discount rate would tend, at least in the short-run, to ratchet market rates upwards rather abruptly. Banks are ordinarily reluctant to borrow from the Federal Reserve banks, so the Federal funds rate will tend, in such periods, to move above the discount rate (in turn "forcing" still another discount rate increase.) In that way, the function of the discount window as a buffer that contributes to orderly market adjustments would be vitiated. That problem does not exist where borrowings are low and interest rates are tending to decline, but in those circumstances the discount rate does tend to become a penalty rate. On grounds of monetary control and efficient administration of the discount window, there are arguments for keeping the discount rates as close as is practical to market rates, and at a penalty to such rates. Moreover, such a practice would avoid some "announcement" effects; depending on circumstances, that is a gain or loss. The surcharge for frequent borrowing by large banks introduced last spring was an effort to reconcile some of the advantages and disadvantages of discretionary handling of the discount rate. We feel that approach has enough promise to keep it in our complement of policy instruments for use in appropriate circumstances. Moreover, the entire question will be reviewed as we gain experience under the Monetary Control Act.

Response to question on whether Fed has intervened to maintain interest rates to protect the dollar

Basically, the Federal Reserve has adhered to the procedures introduced last October to influence growth in the money supply by setting, and following, certain reserve paths. This procedure was described in material provided the Committee earlier. In that context, the fluctuations of market interest rates over the past several months have been broadly caused by changes in the intensity of money and credit demands relative to the supply of money and bank reserves that the Federal Reserve has been targeting. Thus, interest rates have been determined by market forces. This is also true of the last several weeks.

By way of background, the FOMC does set forth rather broad ranges for the Federal funds rate felt to be consistent at a point in time with its reserve targeting and policy intentions. Occasionally, when market rates were rising or falling, these "limits" (which are not rigidly interpreted) have been reached. Experience shows that the "limits" have typically been considered by the Committee as a kind of "check point" for reviewing its policy decisions, but in no case has any substantial change in reserve targets been made simply because the "Federal funds" check point has been reached; typically, if significant inconsistency appears likely, it is the Federal funds limit that has given way.

With regard to operations of the past few months, the aggressiveness with which the Fed sought to make up the short-fall from targets in the spring was influenced by technical questions about the significance of the short-fall and by implications of a more or less rapid "make-up" on perceptions in domestic markets, and in particular on inflationary expectations. The impact on foreign exchange markets has also been a matter of discussion, related to the effects of exaggerated interest rate movements on exchange rates. Similar considerations -- domestic and foreign -- no doubt entered into judgments on setting the appropriate Federal funds rate "check points."

More technically, the precise timing of action day by day -- either of discount rate changes or through open market operations to achieve the planned reserve path -- has, on occasion, been influenced by the day-to-day condition of the exchange markets and by the desire to avoid "false signals" of our intentions. Similar considerations may occasionally arise with respect to domestic markets. (In either case, I must emphasize that this is not the norm; the tendency of some market observers to read significance for "policy" into the timing or nature of our almost daily operations related to the provision or reduction of reserves is simply not warranted.)

I believe we have learned from hard experience that the broad international consequences of our policy-making can be ignored only at our peril -- that acute weakness in the dollar externally can become for a time self-reinforcing and contribute to inflation and uncertainty at home. In that sense, foreign exchange market concerns are inevitably one of many ingredients in our decisions. But such concerns are virtually indistinguishable in my mind from the much broader question of perceptions of our policies at home as well as abroad in keeping monetary growth under control and maintaining an appropriate anti-inflationary stance. I do not believe that concerns about foreign exchange markets have posed in recent months any dilemma with respect to reserve targeting or interest rate constraints -- targets and constraints that appeared fully appropriate on domestic grounds and in light of basic policy objectives.

Response to question on policies to reduce inflation when demand is picking up

If the underlying rate of inflation remains at 9 or 10 percent, as your question suggests, it will indeed be difficult to have any more than a sluggish economic recovery. As I have indicated in my testimony, if the Federal Reserve is pursuing anti-inflationary policies, working toward reducing monetary growth, while other sectors are pursuing inflationary policies, a kind of "collision" sooner or later is virtually inevitable. One outcome could be more sluggish growth than we would like to see for some time. Another could be the increasing realization that the Federal Reserve will indeed continue its anti-inflationary stance and that, therefore, policies of restraint in other spheres -- particularly in the wage and price area, as well as in fiscal policy -- will be more conducive to recovery and real growth than policies that ratchet up the cost and price structure. Prospects for more vigorous economic growth will be enhanced to the extent that wage and price restraint is accompanied by necessary improvements in our productivity performance.

It is these issues to which the latter part of my statement before the Committee was directed, and why I believe it is so counterproductive to continue other policies that tend to push up costs or to undertake tax reductions before certain conditions are met.